

Comparative Study on Third Party Rights

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Declaration

I hereby declare that this thesis is my own composition and that the research reported here has been conducted by myself unless otherwise indicated.

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Edinburgh, 29 March 2007

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Abstract

The common traditional legal concept is that privity doctrine is a basic principle in the contract law, which was also introduced into the Chinese contract law. This doctrine has, however, been put under pressure as a result of the tendency towards the reform of third parties' rights. The idea behind this development is that the third parties' rights to get benefits from the contract and obtain contractual remedies should be recognized by the law if it is the contracting parties' intention. As a result of this, a lot of countries have accepted the third parties' rights by creating exceptions to the privity or establishing specific legal provisions. This thesis reviews the many countries' laws on third parties' rights, and compares various theories and decisions of the cases. Based on the discussion of the Chinese historical legal development and existing legal status, an attempt is made to explain that the third parties' rule should also be reformed in China. The central question to be discussed is what the existing problems in other countries are and what rules are better to be adopted in China.

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CHAPTER 1

INTRODUCTION TO CHINESE CONTRACT LAW

1.1 Historical review of the Chinese Contract Law

1.1.1 From 1840 to 1950

In the 19th century, Chinese Law was strongly influenced by the Civil Law systems. Many new legal concepts and principles, especially those about private laws, were introduced directly or indirectly from countries such as Germany, France and Japan which itself was much affected by French and German Law. Following the same method of these countries' laws to regulate the business activities, Chinese laws and rules gradually changed from criminal-regulation¹ to multi-regulation. This emerged during the process of establishment of the Chinese private law system.

In 1840, during the late Qing Dynasty, the Opium War broke out. From then on western countries' culture was introduced into China and many Chinese scholars began to learn from Western legal systems. In 1862, the government of the Qing Dynasty established an education institute, Tong Wen Bureau, which was in charge of cultivating Chinese people to learn foreign languages. An American, William Alexander Parsons Martin,² who was the chief instructor of Tong Wen Bureau,

¹ Punishment for a person who fails to do business with others according to customs and regulations was corporal punishment and pecuniary penalty.

² (1827-1916), Missionary of American Presbyterians North.

translated *Elements of International Law*³ into Chinese in 1867. In 1880, a French instructor, Billequin Anatole Adrien,⁴ translated French Civil Code into Chinese under the title of *The French Regulations*. The Chinese version of the *French Regulations* was the first integrated version of foreign law in Chinese history, and in the late 19th Century, it was put into use as a textbook in education.⁵ During this period, Tong Wen Bureau published many works on introduction of western countries' laws, including *Introduction to the Study of International Law*⁶ and *A Treatise on International Law*.⁷

One of the most famous Chinese scholars, Shen Jiaben⁸, the Minister of the Qing Dynasty who was in charge of legal reform at that time contributed greatly to the introduction of foreign laws. He proposed that the Qing government should reform the laws by studying western countries' laws. In his works, he compared the different cultures between China and western countries, pointed out that the Chinese legal system was in a backward state, explained why it prevented development of the country, and discussed advantages of introducing foreign laws.⁹ Shen Jiaben also did a lot of work for compilation of foreign laws. He encouraged Chinese people to study laws abroad, and also invited scholars from abroad to translate foreign laws. In the late 19th Century, many Chinese scholars who studied in Japan and other countries came back and contributed to the Chinese legislative reform.

During the period from the 1890s till the 1910s, more foreign laws were introduced into China and their Chinese versions became the reference books when

³ Henry Wheaton, *Elements of International Law*, (1836)

⁴ (1837-1894)

⁵ Tian Tao & Lizhuhuan, "Study on versions foreign law books during the end of Qing Dynasty", *Periodical of Chinese and Foreign laws*, no3 (2000).

⁶ Wrote by T. D. Woolsey. Translated by William Alexander Parsons Martin, Wang Fengyi, Wang Fengzao (1877)

⁷ Wrote by W. E. Hall. Translated by William Alexander Parsons Martin (1880)

⁸ (1840- 1913), Shen Jiaben is regarded as the first person who contributed to Comparative law in Chinese history.

⁹ Shen Jiaben expressed the opinions in his books: *Study on Legal Theory*, *Comments on Statutes of Qing*, *General Legal Concepts and Principles of Legislation*.

the laws were modified or new laws were enacted. The Government of Qing established the Commerce Bureau, one of the leading legislative bodies, to promulgate commercial laws and other related laws. One of its functions was to translate other countries' commercial laws and treaties into Chinese versions. According to the records and statistics made by Shen Jiaben in 1909, the versions of the foreign laws included German Civil Law, German Marine Law, German Bankruptcy Law, French Civil Law, Austrian Civil Law, Japanese Civil Law Japanese Commercial Law, Japanese Commercial Instrument Law and American Bankrupt Law.¹⁰ In addition, there were also many periodicals about studying foreign laws appearing, in the meantime, such as *Journal of Law and Politics* (JiaoTong Press) and *Journal of European and American Law Studies*. Both official organs and the civilian organizations focused on studying German Law and Japanese Law at that time¹¹ because (i) they realized the great success of Japan in establishing a satisfying legal system through following the German experience in legislation; (ii) a lot of scholars went to Japan to study law and they were good at both Chinese and Japanese language. This made it possible for them to conduct deeper research on Japanese laws.

In 1907, Shen Jiaben, Yu Liansan and Yin Rui were appointed by the government to take charge of law reform. An organization, the Law Revision Office was set up. Shen Jiaben invited Japanese experts and scholars to join for the preparation of draft of a civil code. The draft work formally began in 1908, and a new Civil Code, entitled the *Draft Civil Code of the Great Qing*, was completed in 1910. This code had not been put into force before Qing Dynasty ended in 1911. However, it was the first comprehensive civil law in the Chinese history. The code was mostly patterned after the Civil Law¹² and therefore fixed the direction of development of the Chinese civil

¹⁰ Li Huilian, About Shenjiaben, p. 210-211, Law Press 2000.

¹¹ He Tiechuan, "Oversea Chinese Students and Legal System in 20th Century". Law Study, no 6 (1997).

¹² The Draft Civil Code of the Great Qing was enacted under the assistance of some Japanese and it contains a large number of provisions, which are similar with those in Japanese Civil Code at that time. As Japanese Civil law is modelled mostly after German Civil Code, therefore some scholars pointed

law afterwards.

Draft Civil Code of the Great Qing consisted of three parts - general principles, obligations and rights in things. In the general principles part, four fundamental principles were established: equality, protection of private property, freedom of contract and the doctrine of negligence. Not only the explanation of these principles, but also the way they were classified and compiled, were originally introduced from the French Civil Code.¹³ As later the German Civil Code and the Japanese Civil Code followed these principles but made a great improvement on them, these modified doctrines were introduced into the Draft Civil Code of Qing.

The section of the Draft Civil Code of Qing concerning specific rules, contained many transplanted regulations, which were quite strange to China at that time, for example, concept of legal entities, obligatory rights and rights in things. These provisions were given more detailed interpretation when they were put into judicial practice.¹⁴

During 1929-1930, the Guomindang government promulgated a Civil Code, which reflected a basic continuity with the Draft Civil Code of the Great Qing in customs and patterns. Furthermore, it had more common characteristics with the German Civil Law and Japanese Civil Law because the Guomindang Civil Code was created in order to regulate a capitalist economy, instead of a feudal-farming economy. For example, the Guomindang Civil Code highly emphasised each party's equality and freedom to join civil activities and protection of personal property. It provided

out that Draft Civil Code of Great Qing was actually patterned after the German model. See Wang Liming & Cui Jianyuan 'New Study on Contract Law' p.86, China Zhengfa University Press 2000.

¹³ Equality Principle is from article 8, article 7 and article 488 of French Civil Code. Protecting Private Property is from article 544 and article 552 of French Civil Code. Freedom of Contract is mainly from article 1101; Doctrine of Negligent is from article 1382 of French Civil Code.

¹⁴ Regulations about legal entities are from article 60 to article 165. The whole chapter 2 is about obligatory rights and the whole chapter three is about rights in things. Draft Civil Code of Great Qing.

that a contract was concluded when the parties reciprocally declared their concordant intentions either expressly or tacitly.¹⁵ The basic view that a contract was a binding agreement between the contracting parties was extended throughout provisions on contract in the Code. This approach, encapsulating the principle of a modern, capitalist market economy, was the governing notion of the German Civil Code 1900.¹⁶

In summary, there are three main reasons to explain why from 1840 to 1930 the Chinese civil law and contract law followed the Civilian tradition.

1. The way to classify the Chinese civil law followed Civilian style. Contract laws were part of the Chinese Civil Code; they had the same fundamental principles with other parts of the Civil Codes. Any contractual activities should be in conformity with the general regulations of the Civil Codes.
2. The definition of term 'contract' was also introduced from the Civil Law system – contract was an agreement between an obligee and an obligor. This definition was different from the concept of contract in Common law system which regarded contract as an exchange of promises.
3. The Common Law's consideration doctrine had never been introduced into those Chinese civil codes and contract laws.

1.1.2 From 1950 to 1979

After the current Chinese Government came into power in 1949, all the existing laws

¹⁵ The Civil Code of Republic of China 1930, Book 2, Chapter 1, Article 153.

¹⁶ Philip C.C. Huang, *Code, Custom and Legal Practice in China* (2001), p. 58, Stanford University Press,

were abolished.¹⁷ In 1950, a compiled statute, Interim Procedures on Conclusion of Contracts among Government Agencies, State-owned Enterprises and Cooperatives,¹⁸ was issued by the Financial and Economic Committee of the State Council. It was regarded as the first contract law since 1949.¹⁹ The main content of the statute was some basic legal conceptions such as the definition of contract, contracting parties' qualification and position, subject-matter of contract, and contractual rights and obligations. Interim Procedures worked well in regulating trade between government representatives and cooperatives at this stage. However, the lower productivity and economic crisis decided that the Interim Procedures could not function as a general contract law. This is because:

1. The status of the economy decided that contracts themselves did not play an important role in the country's economy. During this period, the Chinese economy was sick - no open market and no free competition. Agricultural and industrial products were far from enough to supply demand. There were few business transactions in the economic life.
2. The statute excluded natural persons from entering into an economic contract. Only government agencies, state-owned enterprises and cooperatives could become contracting parties.
3. Only a few types of commercial transactions were regulated by statutes - sale of goods, loan, barter, consignment, transportation, orders for manufacturing, joint ventures and construction.

From the late 1950s, China gradually established the state-planned economy.

¹⁷ Guiguo Wang, "The New Contract Law of China", p.242, Journal of Contract Law (2000).

¹⁸ The Chinese text of the regulation can be found in Wang Zhong, Li Quanyi & Zhou Zhiyuan, 'Economic Contract Law handbook', Jilin University Press, 1984.

¹⁹ Wu Jianping, Study on Contract, p. 19, China Jiancha Press.

Accordingly, the state's plans and policies had a core position in regulating business transactions in China. As a matter of fact, the contract regulations which were enacted during this period were only the legal representation of the state's plans. From the 1950s through the 1960s, more than forty regulations about contracts were promulgated by the Ministries of State Council in China.²⁰

No unified civil code or contract law was enacted. Each statute functioned to regulate specific types of contracts. For example, those contracts concerning agricultural business were promulgated by the Agriculture Ministry. The Industry Ministry was responsible to enact statutes which regulated the contracts in industrial business. In addition, the National Committee and the Party also had the right to issue the statutes. For instance, the *Interim Regulation on Contracts for Ordering Industrial and Mineral Products* was promulgated by the Industry Ministry in 1963. The Communist Party Central Committee and State Council jointly issued a *Notice Regarding Strict Implementation of Basic Construction Procedure and Economic Contracts* in 1962.

As each statute was made on the basis of certain policies of the State, the content of contracts had to be in accordance with them. As a result, the statutes particularly fixed the uniform price of certain products, uniform standard of quality, quantity limitation and even method of delivery and payment. Those contracts which were made in breach of the statutory provisions would not take legal effect.

During this period, the contract regulations which were established in accordance with the State's policies showed that enacting statutes was just a way to effectuate the government's policies and realize them in practice. This is the major feature of a pure

²⁰ Regulations issued by State Council, subsidiary commissions and ministries or local governments were named administrative regulations. They were parts of Chinese legal statutes. According to article 89 of the Chinese Constitution 1954, State Council also had rule-making power. The rules made by Ministries and local government had legal effect. They were more detailed and specific concerning certain types of transactions.

planned economy system. Factories and enterprises, as basic components and participants in Chinese economic society, had no individual decision-making power. For example, what and how many products they should produce every month or every year was decided by the government but did not depend on the requirements of the market.²¹ Freedom of contract was not a principle in these statutes. Indeed, this kind of economy system worked well at the first stage in the 1960s but with the development of economy it became more and more obsolete since 1965. Practical experiences and a large numbers of facts made it clear that the planned economy system was in urgent need of change. The main reasons for requirements of economic transformation were:

First, the government could not make accurate plans on aggregate output of agricultural and industrial products when the capability of production gradually increased. The policies did not promote productivity, but instead they became obstacles to the development of economy.²²

Secondly, enterprises were owned by the State or cooperatives and there was no competition relation among them. Production of goods was not based on market profitability. In absence of enterprises' motivation to improve productivity, the development of economy slowed down.²³

1.1.3 From 1979 to 1999

²¹ Article 17 of the 1961 Interim Regulation on Contracts for Agricultural Products

²² Chang Xiuze, *Revolution of the Chinese Economy*, (1994) p.52, Tianjin People's Press; Mo Tianqi, *Economic Transformation and Development of the Society*, (1999) p.384, Hubei People's Press; Zhao Xiao, *Economic Transformation in China*, (1995) p.62, Keji Press

²³ Liu Rui, "Economic Transformation in China and Future Directions", (2004) Issue No 5 Renmin University Press 65; Wu JingLian, *Reform of Economic System*, (2004) p.128, Shanghai Yuandong Press; Chen Zhao, *Enterprises in the Economic Transformation – Ownership and Governance Reform*, (2004) p.79, Shanghai Sanlian and Shanghai People's Press

1.1.3.1 The Chinese Constitution

In 1979, the Chinese government began to change economic policies, especially to reform the planned economy system. The new economic policies decentralised the state's control, gave business entities independence and decision-making power, developed private business and attracted foreign investment. This radical change of economic policies also brought the beginnings of legal reform in China. From 1979 to 1981, a large number of new contract regulations were promulgated.²⁴

The new economic policies were so significant and fundamental that they had first to be confirmed in the Chinese Constitution.²⁵ In 1980, the third conference of the National People's Congress decided to set up a special committee to modify and develop the Constitution so that the revised Constitution could meet the requirements of the Chinese economy reform. In December 1982, a new Constitution came into being.²⁶ It made the following major changes:

1. It established the institution of diversified proprietorship, including state proprietorship, collective proprietorship and all kinds of private proprietorship.

²⁴ These contract regulations included Joint Notice of the State Economic Committee, the General Administration of Industry and Commerce, the People's Bank of China on several Questions Concerning the Administration of the Economic Contracts 1979 (reprinted in 'Chinese in Manual of Economic Contract Law' by Wang Zhong, Li Quanyi & Zhou Zhiyuan, ed.1985, 34-37), Provisions of the General Administration of Industry and Commerce on Basic Clauses of Economic Contracts between Commercial and Agricultural Sectors 1980, Regulations on Contracts for Industrial and Mineral Products 1981.

²⁵ The first Chinese Constitution since 1949 was promulgated in 1954 on the basis of the Chinese General Creed. The General Creed came into being in 1949. Its whole name is General Creed of Politics Conference. Main contents of it come from the statutes enacted by Chinese Communist Party during the period of revolutionary war and some other contents were introduced from former Soviet Union. Then the Constitution was modified in 1975 and 1978 respectively but the result of modification proved to be unsatisfactory.

²⁶ Chinese text of Constitution 1982 can be found in Law, Regulations and Judicial Interpretation of People's Republic of China, (2002) pp.3-14, China FangZheng Press

2. State-owned and collective enterprises were given independent decision-making power to some extent.
3. It recognised that the market played an important role in regulating the economy.
4. It showed that the Chinese economy was in an intermediate stage. Article 15 of the 1982 Constitution provided that: “The main Chinese economic system is still a planned system which balances the whole social economy, but the market’s regulating function should also be brought into play. Every one is prohibited to break the state’s economic order.” Article 17 stated that enterprises had their own decision-making power on the premise that they abided by the instructions of State’s plans and laws.

1.1.3.2 Three Contract Statutes

The Chinese Economic Contract Law (hereafter ECL)²⁷ was enacted in 1981 and put into force in 1982. During the process of legislation, more than 6,000 experts and jurists at more than 600 meetings and conferences discussed the draft of the ECL. It was modified on the basis of the former contract regulations,²⁸ the courts’ judicial interpretations, the decrees of typical cases and the product of legal research. Therefore, the main contents and fundamental principles of the previous regulations were reiterated in the ECL. However, one of the most important differences was that ECL recognised the importance of freedom of contract and to some extent reduced the

²⁷ The Chinese text and an English translation of the new ECL can be found in *China Laws for Foreign Business*, paragraph 5-500, CCH Australia Ltd., 1993 ed (hereafter as CLFB). The English text can be found on the website: www.chinalawinfo.com/Database/LawRegulation, 11 July 2002.

²⁸ The former contract regulations were referred to those regulations promulgated from the 1950s to the 1960s, see above para. 1.1.2

influence of government's policies on contracts. Generally speaking, the fundamental principles of contract law were described as follows:

- (a) Any party had equal rights when he entered into a contract.
- (b) A concluded contract was based on both contracting parties' free wills. One party had no right to force another one to enter into a contract.
- (c) Contracting parties enjoyed contractual rights and performed contractual obligations equally.
- (d) A third person had no right to intervene in relations between contracting parties.²⁹ The third person here means any natural person, legal entity, cooperative and governmental authority.³⁰

In order to adapt to the development of economy, the ECL made further progress – it emphasised the important role of contract in the Chinese market economy to some extent and also showed its function to regulate a market economy. According to article 1 of Chapter 1, the aim of the ECL was to guarantee the development of a market economy, to protect lawful rights and interests of contracting parties, to maintain social economic order, and to promote the progress of modernization in China.

On the other hand, based on Chinese economic status, due to the lack of practical experience, the reform of a planned economy required substantial time for proper completion. Accordingly, the specific statutes were required. This was shown in those provisions of the ECL in which the government's policies remained influential on contents of contracts to some extent. For example, under article 11, if the government had made some plans on certain products, relevant contractual provisions should be made in accordance with those policies. Otherwise the contract would take no legal effect. Change of the state's plans gave a legal reason for termination or modification

²⁹ Article 5 of the 1981 Chinese ECL.

³⁰ Governmental authorities should not intervene in the conclusion of contracts or performance of contracts unless statutory provisions allowed them to do so in some circumstances.

of a contract.³¹ Under article 17, the quantity and quality of the subject matter, the contract price, the payment methods and transfer of the contract rights or obligations should be consistent with the government's policies. Only where there was no applicable policy, had the contracting parties the right to make their own decisions. Article 44 provided that local governments had the rights to supervise contracts. As a result of the existence of the above provisions, some Chinese scholars argued that the Economic Contract Law 1981 had not truly adopted the principle of freedom of contract.³²

With the development of international business, in 1985 the Chinese legislature promulgated the Economic Contract Involving Foreign Interests Law (hereafter FECL) which specifically regulated a contract between one domestic party and one foreign party. FECL covered almost all foreign commercial activities in China, including finance, trade, service and investment. The major provisions of the FECL were from previous Chinese contract regulations and some practical experiences. During the process of legislation the legislators also referred to the Vienna Convention on Contracts for the International Sale of Goods (hereafter CISG), European legal systems and Common Law legal system. Under article 6 of the FECL, all the international conventions in which China had participated had priority to be applied if their provisions were different from those of the FECL, unless the provisions were declared to be reserved.³³ The basic principles and provisions in the FECL were similar to those in the ECL, but the difference was that FECL put less government control on the content of contracts and emphasised freedom of contract more because the FECL applied to contracts in which at least one of the contracting parties was

³¹ Article 7 of the 1981 Chinese ECL.

³² Liu Ruifu, *General Theory on Contract Law*, (1998) p.38, Law Press; Su HuiXiang, *Chinese Contemporary Law*, (1997) p.34, Liaoning Press.

³³ China became a member of CISG in 1986, and reserved Art 1(b) and Art 11. Art 1 (b) of CISG provides for the use of the Convention: 'when the rules of private international law lead to the application of the law of a Contracting State'. Reservation of Article 11 of CISG meant that the contracts took no legal effect in China if they were concluded in oral.

non-Chinese.

The first statute concerning contracts for intellectual property – the Technology Contract Law (hereafter TCL) - came into being in 1987. The law was enacted for the purpose of protecting intellectual property and keeping pace with improvements in the developed countries. It also provided that all contracting parties were equal and free to enter into contracts and they had equal rights. The TCL covered the following four basic types of contracts: technology development contracts, technology transfer contracts, technology consultation contracts and technology service contracts.

These statutes were the most important contract statutes in China during the period of transition for the economic system beginning in 1979. Although they regulated different types of contracts, they had common characteristics. First, the principle of freedom of contract was established formally in all three contract statutes, and the principle was put into practice as well. Second, the three statutes all abandoned old legal conceptions based on the pure planned economy and began to emphasise the importance of the market economy.

1.1.3.3 The Chinese Civil Code

Work to draft the Chinese civil law began in 1954. The first Draft was finished in 1958 and it consisted of five chapters and 525 articles. It included general principles, property rights, obligation and inheritance. Some rules in this Draft were introduced from the 1922 Civil Code of the Soviet Union. For example, the Draft especially emphasised the protection of common property owned by the State or cooperatives. The Draft adopted legal concept of ‘ownership’ and excluded the concept of ‘right of things’. It also replaced the notion of ‘natural person’ with the notion of ‘citizen’.³⁴ In 1979, the Legal Committee of the National People’s Congress founded a group in

³⁴ Wei Zhenying & Zhang Shanpin, *A Basic Law Concerning the Development of National Economy and Interests of Citizens, Democracy and Legal System*, 1986, No5.

charge of drafting a civil code.³⁵ The drafting group held 380 conferences, considering comments and opinions from scholars, judges, prosecutors, lawyers, experts and some foreign consultants as well. The 1964 Civil Code of the Soviet Union and the revised Civil Code 1978 of Hungary were introduced into discussion. In 1986, the Civil Law of the People's Republic of China was formally enacted. It is a comprehensive statute which regulates all the relations among equal parties. It provides the general principles and theories such as claims in contract³⁶, intellectual property rights, personality rights, right in things, liabilities for breach (including remedies), tort and time limits for action.

The purpose of the Civil Code is to regulate business activities among equal parties.³⁷ Its principle is that parties join in business activities freely and equally without interference from administrative authorities or the State's power. Article 6 of the Civil Code stipulates that civil activities must be processed according to the laws; only where there is no provision of law, can the State's policy be applied. This showed that the Chinese Civil law was no longer regarded as a tool to implement the State's plans but became independent in regulating economy. As contract laws are one part of the Chinese Civil Code,³⁸ all the fundamental principles of the Chinese Civil Code are

³⁵ Daily of Chinese Legal System, June 12, 1981.

³⁶ Claim in contract here means all the obligee's rights arising from the contract, compared to contractual rights which are referred to contracting parties' all the rights arising from both contracts and laws.

³⁷ According to Chinese Civil Code and contract laws, if all the parties participate in economic activities freely and they bargain with each other in accordance with the principle of fairness in market economy, their legal status are equal. Article 2 of the Chinese Civil Code that the following relations are regulated by civil code: citizens (physical persons) and citizens, citizens and enterprises (corporate bodies), enterprises and enterprises.

³⁸ According to the Chinese legal conception and division of branch law, Civil Code is a part of private law because there is no public (government) authority involved in the relations among all parties. Even if sometimes the state governments enter into activities regulated by private law, they have the equal legal status with other parties regardless of their public power. According to the content of Chinese Civil Code, there are four foundations to create obligations: (i) contractual obligations and rights (claim in contract) are produced when two parties enter into a contract. These activities of contracting parties to enter into contracts are particularly regulated by the contract laws; (ii) due to a party's (manager's) act on voluntary service, the contra-party bears obligations to compensate manager's loss arising from

shared with contract laws. In this regard, the completion of the Civil Code resulted in the improvement of the Chinese contract laws.

1.1.3.4 Constitution Revision

With the development of the economy, it became clearer that the planned economy system was no longer suitable. Practical experiences proved that government intervention had become a barrier to the development of the economy. Instead, an independent open market system with fair and competitive trade was required. Therefore, in 1993 the Chinese Constitution was modified again. Article 15 was changed from “the Chinese economy is a planned economy with limited market adjustment” to “the basic economy is a market economy”. Article 9 also provided that the only rules for all enterprises to follow are Chinese laws, instead of government policies or plans.

1.1.3.5 Call for reform

From the beginning of the 1990s, some academics, judges and practitioners called for the reform of the statutes about commerce. They argued that law reform should meet with the requirements of the development of the market economy system. Three points were especially emphasised in their argument:

1. The fundamental principles of the Chinese private law should be freedom, equality, fairness and justice. Freedom is regarded as the most important one among these.
2. As all parties entering into civil activities were in equal positions, the same statutes should be applied, whether these parties are domestic or from

service; (iii) one party ought to take on obligations towards another party because of unjust benefit; (iv) a party has to bear tort liability due to his act of tort.

foreign countries. They enter into the business activities under fair and competitive circumstances.

3. It was argued that introduction of laws from the developed countries must be helpful as a guidance in regulating a market economy. But on the other hand, those legal theories should be compatible with the particular Chinese economic situations and applicable in practice.

The reform of the Chinese contract laws especially became one of the most debated topics. Most of the academics argued that contract laws should be modified for the following two main reasons:

1. The Chinese contract law system was complicated and confusing. The main statutes include the Civil Code, the ECL, the FECL, and the TCL. In addition, there were a large number of administrative rules and judicial interpretations. They all took effect and were applicable in practice. However, the different regulations were enacted at different stages just to satisfy the specific requirements of economic development and match the different state's policies at that time, so some of them conflicted with each other. The problems arose in practice as well due to application of complex contract regulations at the same time. Such a co-existence of the contract regulations was severely criticised by scholars and practitioners.³⁹ They advocated establishing a new comprehensive and unitary contract law.⁴⁰
2. It was pointed out that the basic principles which were established in the existing contract laws did not meet the requirements of the new economic

³⁹ Ye Xiaoxin, *Chinese Civil Law's History*, (2000) Shanghai Renming Press; Wang Liming & Cui Jianyuan, *New Study on Contract Law*, (2000) p.92, China Zhengfa University Press; Guiguo Wang, "The New Contract Law of China", (2000) *Journal of Contract Law* 243

⁴⁰ It became a coconsciousness that China needs a new contract code. Wang Liming & Cui Jianyuan, *New Study on Contract Law*, (2000) China Zhengfa University Press.

system. The interference of government was still embodied in some provisions such as article 17 and 44 of the ECL. Article 17 provided that the quantity and quality of the subject matter, the contract price, the payment methods and transfer of the contract rights or obligations should be consistent with the government's policies. Only where there was no applicable policy, had the contracting parties the right to make their own decisions. Article 44 provided that the local governments had the rights to supervise all the contracts.

During this period, research on legal theories also contributed a lot to the Chinese law reform. Generally speaking, the achievements can be divided into three aspects. One aspect is research on the history of Chinese private law.⁴¹ Another is research on the current problems, especially the relation between Chinese economy and legislation.⁴² The third aspect of achievement is research on foreign laws and comparative law.⁴³ Those works on comparative law introduced other legal systems, analysed their concepts, functions and practical values.

1.1.3.6 The Chinese Economic Contract Law Modification

In 1993 the Economic Contract Law was modified and the following important

⁴¹ Ye Xiaoxin, *Chinese Civil Law's History*, Shanghai Renming Press, which gave a general research of progress of Chinese civil law and some theoretical problems; Dong Ansheng's *Civil Jurisdiction Act*, China Renming University Press, which explained the historical reasons why the legal system of civil jurisdiction act existed, the area of application of the system, the merits of freedom of contract, main content of the regulations about civil jurisdiction act and related method to control it.

⁴² Wang liming, *On Liabilities For Breach of Contract*, (1996) China Zhengfa university Press; Ma Junju, "Market Economy and Development in Chinese Civil Law", (1996) issue no.4 *Law Forum*; Sun peng, "Security of Trade and Protection Function of Civil Law and Commercial Law", (1995) *Law Science*, issue no.15.

⁴³ Wang Jun, *American Contract Law and Amercian Case*, (1996) China Zhengfa University Press; Zhou Xiaoming, *Comparative Trust Law*, (1996) Law Press; Chu Jian, *German Civil Law and Commercial Law*, (1996) China Dabake Press; Fei Anling, *Italian Civil Code*, (1997) China Dabaike Press.

changes were made.

1. The purpose of the Economic Contract Law changed from “to assure the implementation of Chinese State’s policies”,⁴⁴ to “to assure the development of the Chinese market economy”.⁴⁵
2. The modification deleted the provision providing that the validity of contracts was decided by administrative organs, and replaced it with the provision providing that validity of contracts was decided by the decisions of courts or arbitration agencies.⁴⁶
3. The arbitration clause was changed. The Economic Contract Law of 1981 provided that the contracting parties were entitled to bring a suit to court if they were not satisfied with the arbitral decision. The modification deleted this and provided that the arbitration decision had final legal validity.⁴⁷

1.2 Chinese Contract Law 1999

1.2.1 Background

However, the The Revised Economic Contract Law did not drastically change the situation, and problems still existed in China after 1993.

First, the situation that the ECL, the FECL and the TCL regulated different types of contracts and that they were applied respectively in practice did not change. The

⁴⁴ Article 1 of the 1981 Chinese ECL.

⁴⁵ Article 1 of the 1993 Economic Contract Law Modification.

⁴⁶ Article 5 of the 1993 Modified Act of Economic Contract Law.

⁴⁷ Article 28 of the 1993 Modified Act of Economic Contract Law.

complexity of the contract laws caused confusion and uncertainty in the courts' decisions. A new unified contract law was required. Second, it was argued that a new contract law should have the same basic principles as those in most other country's laws in order to promote international business cooperation and development. In addition to principles such as freedom of contract and justice, some basic theories about conclusion of contracts, validity of contracts, contracting parties' rights and obligations and remedies should also be made in common with other countries' laws. China should not ignore the tendency that more and more international treaties and regional unified laws had been created or going to be established.

In 1993 the Chinese Legislature recommended the enactment of a new contract law. The judges, scholars and experts proposed a report named "Draft Proposal of Contract Law". In 1995, legislative council set a conference to discuss the Draft and followed some scholars' and experts' advice to modify it to "Draft Proposal of Contract Law II."

The new Chinese Contract Law was issued in 1999. It includes general contract provisions, including ones on conclusion of contract, effectiveness, performance, modification and assignment, termination and liabilities for breach, as well as specific regulations on different types of contracts. It adds some new regulations in accordance with the requirements of economic reform, and extracts experiences from judicial practice and legislative experiences of other developed countries, especially from Germany, France and Japan.⁴⁸ In summary, the new regulations address the obligors' defences (Article 66 and 67), regulations about assurance of contract (Article 69), methods and principles of interpretation of contracts (Article 125), fault liabilities in contracts (Article 42), concurrence of liabilities (Article 122) and agency by estoppel (Article 49). In addition, the 1999 Contract Law reforms the theories about assignment of contracts, and adds rules about some kinds of contracts such as

⁴⁸ Liang Huixing, "From Three Contract Laws to an Uniform Contract Law", (1999) no.5, China Legal Science.

contracts of bailment, brokerage contracts, contracts of commission agency, contracts for financial leasing, employment contracts and contracts of partnership. The new Contract Law also introduces some rules from the Common Law system and some international conventions. For example, doctrines of presumptive wrongs,⁴⁹ anticipatory breach of contract⁵⁰ and foreseeable damages⁵¹ were introduced into the Contract Law. Other rules such as rescission of contract, liabilities for breach of contract, interpretation of contract and contracts of sale, are introduced from the CISG.

1.2.2 Purpose of the law

Under article 1 of the Contract Law, its purpose is to protect the lawful rights and interests of contracting parties, keep economic order and promote the progress of the modernization drive.

The article especially emphasises the protection of rights of contracting parties because each party is an elementary unit in business and realisation of their expectations improves the economy overall.

1.2.3 Definition of contract

The definition of contract adopted in the Contract Law 1999 followed the concept in Civil Law system – a contract is an agreement concluded based on the parties' consensus.⁵² That is, a contract which is regulated by the Contract Law should be a contractual relationship of obligation, which is distinguishable from other relationships created by the law such as delict and unjustified enrichment.⁵³ Under

⁴⁹ Article 42, 43 and 60 of the 1999 Chinese Contract Law

⁵⁰ Article 108 of the 1999 Chinese Contract Law

⁵¹ Article 113 of the 1999 Chinese Contract Law

⁵² Wang Liming & Cui Jianyuan, *New Study on Contract Law*, (2000) p.4, China Zhengfa Press.

⁵³ Liang Huixing, *Study on Theory of Civil Law and Cases*, p.244, ZhengFa University Press.

article 2, contract is an agreement between natural persons, legal persons and other economic organisations for creation, modification and termination of civil rights and civil obligations.⁵⁴

The definition is similar to the one established in the 1986 Civil Code. The difference is that the latter does not explicitly define the scope of contracting parties. Under the Civil Code, a contract is an agreement made between *equal parties*; they enter into a contract for the purpose of creating, modifying and terminating the civil relations between them.⁵⁵ In contrast, the 1999 Contract Law abandons the incorrect concept in the ECL which equated a *contract* with an *economic contract* - a contract is an agreement to create rights and obligations for realisation of a certain economic expectation, and parties to a contract can only be legal entities, economic organisation, individual business people and contractors in countryside.⁵⁶

1.2.4 The fundamental principles

1.2.4.1 Freedom of contract

The new Chinese Contract Law establishes the principle of freedom of contract. The principle is important for realisation of a market economy. It was argued:⁵⁷

One criteria to decide whether China has truly set up the market economy is whether freedom of contract has been confirmed as a fundamental principle in the Civil Code and the Contract Law.

⁵⁴ It is similar to the definition of contract in the Chinese Civil Code - a contract is an agreement between parties for the purpose of creating, modifying and terminating civil relations. See Article 85 of the 1986 Chinese Civil Code

⁵⁵ Article 85 of the 1986 Chinese Civil Law

⁵⁶ Article 2 of the 1981 Economic Contract Law

⁵⁷ Wang Liming, "On Some Theoretical Problems in the Chinese Contract Law", (1999) no.4, China Legal Science

According to articles 3 and 4, the contracting parties have equal legal rights. No party can impose its will on another. They have the right to enter into a contract freely and no organisation or individual can illegally interfere with this right. In addition, as a fundamental principle in the Contract Law, freedom of contract should be embodied throughout the whole Contract Law. With the establishment of freedom of contract, the 1999 Contract Law solved the following problems:

1. Administrative governmental intervention has been reduced although it was not eliminated.⁵⁸ For example, the government's right to confirm validity of contracts was cancelled and the right of supervision is strictly limited.
2. Contracts which are made in oral also take legal effect. This contrasts to the regulations in the ECL, the FECL and the TCL which provided that only contracts made in written had validity.
3. Contract Law protects contracting parties' rights to modify or rescind the contract. The contracting parties have the right to end the contract at any time if they reach an agreement on it. In addition, the contracting parties can freely create preconditions for the validity of the contract.⁵⁹
4. Contracting parties have the right to freely negotiate contractual terms about the amount of damages and compensation for losses, unless the agreed compensation is obviously unreasonable.⁶⁰
5. According to article 7 of the ECL, contracts or contractual terms that break the laws or administrative regulations are invalid. But under the 1999

⁵⁸ Article 127 of the 1999 Contract Law.

⁵⁹ Article 46 of 1999 the Contract Law.

⁶⁰ Article 114 of 1999 the Contract Law.

Contract Law, only the contracts or those contractual terms which break peremptory legal provisions are invalid.⁶¹

1.2.4.2 Justice, honesty and trustworthiness

The new Contract Law also establishes the principles of justice, honesty and trustworthiness. Article 5 provides that the parties shall abide by the principle of fairness in creating contractual rights and obligations. Article 6 prescribes that the parties must act in accordance with the principle of honesty and trustworthiness when they exercise their rights or carry out their obligations.

The principle of honesty and trustworthiness is directly introduced from the concept of *Treu und Glauben* in the German Civil Code. The terminology, honesty and trustworthiness uses translation which has the same meaning with German *Treu und Glauben*.⁶² This principle provided in the Chinese Contract law, is referred to objective good faith that is distinguished from the subjective good faith. In China, objective good faith is regarded as a norm for the conduct of contracting parties: 'acting in accordance with or contrary to good faith'. In practice, the Chinese courts shall determine the requirements of the principle of honesty and trustworthiness in a rational and objective way – such a criteria of its application bears a close similarity to the European and Anglo-American concept of good faith.⁶³ Generally speaking, the principle of honesty and trustworthiness has three functions in the Chinese Contract Law like other systems: an interpretation function (article 125),⁶⁴ a supplementing

⁶¹ Article 52 of the 1999 Contract Law.

⁶² Zhen Qiang, *The Principle of Honesty and Trustworthiness in the Contract Law*, (2000) p.4, Law Press.

⁶³ Martijn W. Hesselink and A.S. Hartkamp, 'The Concept of Good Faith' in *Towards a European Civil Code, Third Fully Revised and Expanded Edition*, 471; Angelo D.M. Forte, *Good Faith in Contract and Property*, (1999) Hart Publishing; J. Beatson and Daniel Friedman, *Good Faith and Fault in Contract Law*, (1997) Clarendon Press, New Edition

⁶⁴ Article 125 of the Chinese Contract Law provides: 'In case of any dispute between the parties concerning the construction of a contract term, the true meaning thereof shall be determined according

function (article 42, article 60 and article 92)⁶⁵ and restricting or limiting function (article 45, article 119 and article 329).⁶⁶

The principles are especially embodied in the following rules:

1. Rules on standard form contracts. In order to control the unreasonable use of standard form contracts and keep both contracting parties' interests in balance, the Contract Law emphasises that the party who made the standard contract provisions shall abide by the principle of justice to define the contractual rights and obligations. He shall also remind the other party to especially note exclusion or limitation clauses, and is responsible for explaining any contractual provision at the

to the words and sentences used in the contract, the relevant provisions and the purpose of the contract, and in accordance with the relevant usage and the principle of good faith'.

⁶⁵ Article 42 of the Chinese Contract Law provides: 'where in the course of concluding a contract, a party engaged in any of the following conducts, thereby causing loss to the other party, it shall be liable for damages: (i) negotiating in bad faith under the pretext of concluding a contract; (ii) intentionally concealing a material fact relating to the conclusion of the contract or supplying false information; (iii) any other conduct which violates the principle of honesty and trustworthiness'. Article 60 of the Chinese Contract Law provides: 'both contracting parties shall perform their own contractual liabilities properly and fully. In line with the principle of honesty and trustworthiness, the third party shall hold the liabilities of information, assistance and keeping secret according to the nature of the contract, aim of transaction and commercial custom'. Article 92 provides: 'Upon discharge of the rights and obligations under a contract, the parties shall abide by the principle of good faith and perform obligations such as notification, assistance and confidentiality in accordance with the relevant usage'.

⁶⁶ Article 45 provides: 'The parties may prescribe that effectiveness of a contract be subject to certain conditions. A contract subject to a condition precedent becomes effective once such condition is satisfied. A contract subject to a condition subsequent is extinguished once such condition is satisfied. Where in order to further its own interests, a party improperly impaired the satisfaction of a condition, the condition is deemed to have been satisfied; where a party improperly facilitated the satisfaction of a condition, the condition is deemed not to have been satisfied'. Article 119 of the Chinese Contract law provides: 'where a party breached the contract, the other party shall take the appropriate measures to prevent further loss; where the other party sustained further loss due to its failure to take the appropriate measures, it may not claim damages for such further loss.' Article 329 provides: 'A technology contract which illegally monopolizes technology, impairs technological advancement or infringes on the technology of a third person is invalid'.

request of the other party.⁶⁷

2. In order to control the party who is in an advantageous position from taking advantage of its superiority and using exemption clauses to avoid its obligations, the Contract Law provides that the contractual provisions will be invalid if liability for physical personal injury, or property damage as a result of intentional acts or gross fault are excluded.⁶⁸
3. Rules on revocable and invalid contracts. A party has the right to ask the court or arbitral tribunal to cancel the contract if there is serious misunderstanding or obvious unfairness. In addition, if a contract is concluded under a party's fraud, duress, threat or undue influence, the innocent party has the right to ask the court or arbitral tribunal to revoke the contract.⁶⁹

1.2.5 Privity doctrine in the 1999 Chinese Contract Law

Generally speaking, the privity doctrine, as a principle in the Chinese Contract Law, contains the following four points:

1. Contractual relations only take legal effect between the contracting parties.
2. Only the contracting parties can exercise contractual rights or bear contractual obligations. A third party does not have to take any contractual obligations or enjoy any rights under the contract.

⁶⁷ Article 39 of the 1999 Contract Law.

⁶⁸ Article 53 of the 1999 Contract Law.

⁶⁹ Article 54 of the 1999 Contract Law.

3. A third party cannot request performance from the contracting parties. Nor can he bring an action based on the contract, unless there are legal provisions allowing them to have such rights.⁷⁰ Some legal provisions are discussed in para. 1.2.6 below.
4. Only contracting parties take liabilities for breach of contract. The contracting parties are not responsible to third parties if they breach the contract, and on the contrary third parties shall not be asked to take liabilities for breach of contract.⁷¹

The privity doctrine was not explicitly provided in the Chinese ECL, the FECL, the TCL or the Civil Code, although it was embodied in the definition of contract. The 1999 Chinese Contract Law reconfirms it by establishing specific provisions. Article 64 provides that where the contracting parties agree that the obligor should perform contractual obligations to a third party, if the obligor fails to fulfill the obligations or his performance does not satisfy the contractual provisions, he holds liabilities only to the obligee for breach of contract. Under this article, the third party can accept the benefits in the contract but has no right to claim remedies if the obligor fails to perform contractual obligations to the third party. Under article 65, where the parties agree that a third party will perform the obligations to the obligee, and the third party fails to perform the obligations or the performance does not meet the terms of the

⁷⁰ Wang Liming & Cui Jianyuan, *New Study on Contract Law*, (2000) p.27, Chinese Zhengfa University Press.

⁷¹ If the obligor cannot perform contract because of a third party's fault, he still has to take the liabilities for breach of contract. After the obligor takes the liabilities for breach of contract he is entitled to ask the third party for recovery the loss. For example, according to article 116 of Chinese Civil Law, one party fails to perform due contractual obligations because of intervene of his superior, he should be responsible for another party's losses or take other remedial measures first, then he has the right to ask for recovery from his superior. Furthermore, in the case of the obligees' rights are infringed directly by the third party, the third party should take responsibility according to the law of tort.

contract, the obligor rather than the third party shall be liable to the obligee for the breach of contract. Under article 121, one party that fails to perform his contractual obligations satisfactorily as a result of a third party's action or inaction, he shall be liable for the breach of contract to the other party. The disputes between the said party and the third party shall be settled according to laws or their own agreements.

1.2.6 Legal theories – exceptions to the privity doctrine

There are some legal rules set up in the Chinese laws as exceptions to the privity doctrine. In these rules, third parties are brought into the contractual relationship – they may exercise the contractual rights, perform the contractual obligations, claim remedies or take on the responsibilities for breach of contract.

1.2.6.1 Agency

The theory of agency is provided for in the 1986 Chinese Civil Code. The basic rule is that agency is the relation between a principal and an agent, and with the principal's consent, the agent can act on his behalf within the agreed limit of authority. One consequence after creation of this relation is that the principal acquires rights from and take liabilities towards third parties.⁷² Under article 66 of the Civil Code, principals never take responsibilities for any results arising from the action of unauthorized agents unless they give ratification. The unauthorised agents have to take responsibilities for their activities without the principals' ratification.

The 1999 Chinese Contract Law follows a similar rule: the parties are entitled to conclude a contract through an agent in accordance with the law. A contract concluded by a person who has no power of agency, who oversteps the power of agency, or whose power of agency has expired, yet who concludes a contract on behalf of the principal, shall have no legally binding force on the principal without ratification by

⁷² Article 63 of the Contract Law 1999

the principal, and the person shall be held liable for his own act.⁷³ In order to protect benefits of counter parties' interests, they can urge the principal to ratify unauthorized agency within one month. It will be regarded as a refusal of ratification if the principal does not make any expression within a month. Within a month a *bona fide* counter party has the right to cancel before the contract is ratified.⁷⁴ According to article 49, where the *bona fide* third party has already trusted that the agent is an authorized one and has relied on the agent's promises, the principal has to answer for the unauthorized act of agency but undoubtedly he has the right to claim against the unauthorized agent for compensation.

Some scholars urged that the nature of contracts for the third party beneficiary could be explained by the agency theory.⁷⁵ They thought that when an agent entered into a contract, his purpose was to make the contract for the principal's benefits. However, this opinion was doubted by other scholars. The details of the debate will be further discussed in part 1.3 below.

1.2.6.2 Assignment

The theory of assignment of contractual rights and obligations is an important theory in the Chinese contract laws. It was first promulgated in the ECL – article 23 provided that the contracting party had the right to assign his whole or part of contractual rights or obligations to a third party, but the assignment takes legal effect only if the other contracting party's approve it. The 1986 Chinese Civil Code stipulates that if one contracting party intends to assign all or part of his contractual rights or obligations to a third party, he has to get approval of the other party.⁷⁶

⁷³ Article 48 of the Contract Law 1999.

⁷⁴ Article 48, Contract Law 1999

⁷⁵ Yu Yanman, 'Study on Contract', Wuhan University Press 1999, 58.

⁷⁶ Article 91 of the Chinese Civil Code 1986.

The theory of assignment becomes more detailed in the 1999 Chinese Contract Law. First, the Law adds provisions concerning those circumstances where assignment should not be allowed. Generally speaking, a contracting party has the right to assign, wholly or in part, his contractual rights to a third party. However, he is prohibited to do this under the following circumstances:⁷⁷

1. The rights under the contract may not be assigned in some cases according to the nature of transactions. Normally three kinds of rights are involved: (i) claims based on personal faith. For example, a bailor's claim in the contract is based on his trust on the personal quality of the bailee. A special faith exists as the basis of parties' contractual relationship.⁷⁸ Supposing the bailee's contractual rights are assigned to a third party, the bailor's interest is likely to be affected; (ii) some contractual rights are related to personal quality such as rights of honor and reputation, right of privacy and right of succession, therefore such contractual rights ought not to be assigned; (iii) as the existence of collateral contractual rights depends on the principal rights, these contractual rights cannot be assigned independently. For example, an obligor's rights in contracts of warranty or mortgage ought not to be assigned.
2. The contractual rights cannot be assigned if both contracting parties have made an agreement to this effect.
3. The rights under the contract cannot be assigned according to the provisions of special laws. For example, under article 61 of the Chinese Guarantee Law,⁷⁹ an obligee's right in the principal contract of the maximum mortgage

⁷⁷ Article 79 of the 1999 Chinese Contract Law.

⁷⁸ Wang Jiafu, *Claim in Contract in the Chinese Civil Code*, (1991) p.74, Law Press

⁷⁹ Guaranty Law of the People's Republic of China adopted at the 14th meeting of the Standing Committee of the Eighth National People's Congress in 1995. The English Edition can be found in

cannot be transferred. Article 91 of the Chinese Civil Code provides that where it is a requirement that the rights arising from some special contracts are assigned with approval of the government authorities, the assignment does not take legal effect without that approval.

Secondly, different from the provision in the Civil Code, the obligee can assign his contractual rights to a third party without the obligor's approval, although he ought to inform the obligor before the assignment. That is, assignment takes effect without approval of the obligor, but it will not become effective if the obligee fails to inform the obligor. The notice of assignment of rights may not be revoked, unless the assignee agrees thereto.⁸⁰

Thirdly, the obligor also has the right to assign his contractual obligations, wholly or in part, to a third party, but he must obtain consent from the obligee.⁸¹ After the assignment of the contractual obligations, the assignee, as a new obligor, is responsible for the performance of the contract. When the contractual rights or obligations are assigned, the collateral rights and obligations are automatically assigned to the assignee, except that the collateral rights exclusively belong to the assignor.⁸²

Fourthly, one party to a contract may assign its rights and obligations under the contract together to a third party with the consent of the other party.⁸³ The result of this kind of assignment is different from the assignment of contractual obligations. Where the contractual obligations are assigned, the assignee will not become a party to the contract; therefore, according to the privity doctrine, the obligee has to sue the

'Laws of the People's Republic of China', (2000) p.1530, Jilin Renming Press or <http://www.civillaw.com.cn/en/article.asp?id=223> 3 Mar 2006

⁸⁰ Article 80 and article 84 of the 1999 Chinese Contract Law

⁸¹ Article 84 of the 1999 Chinese Contract Law

⁸² Article 81 and article 86 of the 1999 Contract Law

⁸³ Article 88 of the 1999 Contract Law

original obligor if the assignee fails to perform his assigned obligations. If a contracting party assigns all his contractual rights and obligations to the assignee, the assignee becomes a party to the contract.⁸⁴

The theory of assignment was also used to create exceptions to the privity doctrine and explain the nature of the contracts for third parties' benefit, but this opinion was rejected by the majority of scholars.⁸⁵ The opinions and the reasons why it is not acceptable will be discussed in the part 1.3 below.

1.2.6.3 Subrogation

The theory of subrogation is introduced in the 1999 Chinese Contract Law. It is regarded as a rule to protect the obligee's contractual rights.⁸⁶ The background to establishing this rule is the fact that in China some obligors pretended to give up their creditor's rights in other contracts for the purpose of avoiding obligations to the obligees. Subrogation is a legal right so the obligee can exercise such a right to take over the obligor's creditor's rights without obtaining the obligor's consent.

According to article 73, if an obligor is indolent in exercising his due creditor's right in another contract, and therefore damages the the obligee's interests, the obligee has the right to request the courts for subrogation in his own name, unless the creditor's right exclusively belongs to the obligor.⁸⁷ The subrogation shall be

⁸⁴ Liu Wenhua, *Explanation and Case Study in Chinese New Contract Law*, (1999) p.91, Universal Books Publisher; Wang Liming & Cui Jianyuan, *New Study on Contract Law*, (2000) p.434, Chinese Zhengfa University Press.

⁸⁵ Yu Yanman, *Study on Contract*, (1999) p.59, Wuhan University Press.

⁸⁶ There are two ways for an obligee to protect his contracting rights actively according to article 74 of the 1999 Chinese Contract Law. One is the obligee's right of cancellation. Another one is subrogation.

⁸⁷ According to the Supreme Court's further interpretation, the obligee may bring an action of subrogation pursuant to article 73 of the Contract Law as long as the following conditions are met: (i) the obligee's claim in contract against the obligor is lawful; (ii) the obligor's act to delay in exercising his creditor's rights has caused damage to the obligee's interest; (iii) the obligor's creditor's claim is due. (iv) the obligor's creditor's right does not contain any personality right. See the Supreme People's

exercised within the scope of the obligor's creditor's right. The necessary expenses caused to the obligee by exercising subrogation shall be borne by the obligor.

It is required by the law that the obligee's subrogation should be exercised appropriately and reasonably. For example, an obligee ought not to exercise subrogation if the obligor already has enough money to perform his obligations. Also the obligee should exercise subrogation according to the principle of honesty and trustworthiness. If the obligor suffers a loss as a result of the obligee's baleful intentions or mistakes, the obligee shall compensate for such losses.

As far as the relation between subrogation and the privity doctrine is concerned, it is generally thought that subrogation theory is an exception to the privity doctrine in the contract laws in that a third party is involved in the performance of contractual obligations.⁸⁸

1.3 Theories on rights of third parties in China

1.3.1 Basic theories on rights of third parties

1.3.1.1 Nature of the contract for third parties' right

The issue about third parties' rights in contracts is hotly debated in Chinese academic domain. Generally speaking, there are two main opinions. One opinion holds that third parties, as strangers to the contracts, should not be allowed to have rights in contracts according to the privity doctrine. An opposite opinion holds that third parties

Court's Interpretations of Certain Issues Concerning the application of the Contract Law of PRC, <http://www.cclaw.net/law%20and%20Regulations/>

⁸⁸ Liu Ruifu, *On General Theories of Contract Law*, (1999) p.38, China Zhengfa University Press.

can get the rights in the contracts and that this may be treated as an exception to the privity doctrine.

The debate begins with the nature of the contracts for third parties' benefits. The opinion which supports recognition of third parties' rights explains its nature on the basis of the following three different theories.

1. There is a theory asserting that a third party gets rights through the assignment of the obligee.⁸⁹ This opinion originated from Civil Law systems,⁹⁰ and some Chinese scholars adopted it and made a further explanation based on the Chinese legal institutions. The difference is that Chinese scholars asserted that not only third parties' right of action but also other rights of claim were based on assignment, such as the right to claim the performance from obligors before the latter breaches the contract. The assignment theory explains why a third party can get rights from a contract and why he has a right of claim, but it still encounters criticism for the following reasons. First, according to the assignment theory, the original contracting parties' intention to conclude a contract is to stipulate contractual rights and obligations for themselves. But in a contract for the third party's right, the contracting parties' intention is to confer benefits on the third party. Secondly, where an obligee wants to assign his contractual rights to a third party, it is not necessary for him to get the approval of the obligor.⁹¹ That is, the obligor cannot prevent the obligee from assigning his rights if he does not want the obligee to do so. But in a contract for the benefit of a third party, the third party's right is based on the agreement of both

⁸⁹ Yu Yanman, *Study on Contract*, p.59, Wuhan University Press.

⁹⁰ K.Zweigert & H.Kotz, *An Introduction to Comparative Law*, 3rd Edition, p.459, Clarendon Press. It was suggested by the Prussian Obertribunal that only a third party's right of suit could be based on assignment.

⁹¹ Article 80 of the 1999 Chinese Contract Law.

contracting parties only.

2. Another opinion explains that the activity of the obligee in entering into a contract for a third party's benefit can be regarded as a management or agency action of the obligee for a third party.⁹² Once the third party accepts it expressly or tacitly, the management action of the obligee is ratified. This opinion also attracts criticism. First, a third party beneficiary gets benefits from the contract only, but he does not take any contractual obligations. However in a contract made through agency, the principal not only enjoys the contractual rights but also bears the contractual liabilities. Secondly, after the agent completes his activity of agency to conclude a contract, he will not be involved in the performance of the contract. However, in a contract for the third party's benefit, the obligee is still the contracting party who exercises his own contractual rights and performs contractual obligations as well.⁹³

3. There is a third opinion which is accepted widely in the Chinese academic domain.⁹⁴ That is, third parties' rights directly originate from the agreement between the contracting parties. It is argued that the contracting parties' intention decides whether the third party can get benefits and right of action from the contract. And the reason why the parties' intention should be recognised by the law is the principle of freedom of contract.

1.3.1.2 Legal effect on the third party

⁹² Yu Yanman, Study on Contract, (1999) p.60, Wuhan University Press 1999.

⁹³ Cheng Muying & Wei Yuerong, "An Exception to the Privity Doctrine – Contracts for the Third Parties' Rights", (2002) issue no. 2, Dangzheng Research Journal.

⁹⁴ Cui Jianyuan, Contract Law, p.37, Law Press 1998; Fu Jingkun, Contract Law in Twentieth Century, (1999) pp153-157, Law Press; Li Guoguang, The Interpretation and Application of Contract Law, Vol. I (1999), p.281, Xinhua Press 1999.

According to the third theory, third parties get the rights directly from a contract once the contract becomes effective, so obligors should perform their contractual obligations to the third parties. The contracting parties can make a contract for a third party's benefits, but the third party decides whether to accept it or not. Only under the condition that the third party accepts the contractual provisions, will the provisions take legal effect. The third parties can accept the provisions expressly or tacitly.

"Passiveness" is described as the characteristic of rights of the third party. What kind of rights the third party may enjoy, how far the rights can be exercised, and in which way the third party enjoys his rights, are all decided by the agreement of the contracting parties. The third party only has the right to accept the contractual provisions or refuse them, but he cannot modify or dissolve them.⁹⁵

According to article 64 of the Chinese Contract Law, the third party has the right to request the obligor's performance but he has no right to bring an action in his own name if the obligor fails to fulfill the contractual obligations or the performance does not satisfy the contractual provisions. On one hand, the Contract Law recognises that third parties can get benefits from contracts, but on the other hand, it does not give up the privity principle. In theory, the provision leads to paradoxical results – a third party has the right to request the benefits during the performance of the contract which means that he can send a notice to the obligor asking for the latter's performance, remind the obligor of his contractual obligations and refix the deadline after the agreed date of performance which should have the same legal effect as it was done by the obligee. Accordingly if the obligor refuses the third party's request, he breaches the contract and thereby takes liabilities for breach of contract.⁹⁶ However, the third party cannot bring an action for the contractual remedies. Professor Liang

⁹⁵ Yu Yanman, *Study on Contract*, (1999) p.61, Wuhan University Press.

⁹⁶ Liu Wenhua, *Explanation and Case Study in Chinese New Contract Law*, (1999) p.68, Universal Books Publisher.

Huixing asserts that article 64 shows the conflict between practical necessity and insistence on traditional legal doctrine.⁹⁷ Most Chinese scholars expressed their objection to article 64, and argued that third party beneficiaries should have a right of action on contracts in their own names because without independent rights of action the third party's benefits can hardly be protected.⁹⁸

Some researchers put forth some one-sided viewpoints. For example, it was thought that according to article 64 the third party has no enforceable right in his own name and he can only rely on the obligee to recover his loss, so article 64 is not actually a provision on the third parties' benefits. In other words the obligor's obligations to perform his promise for the third party is merely a different way to fulfill the promise made to the obligee. The legislature's purpose is still to protect the contractual rights of the obligee.⁹⁹ I do not accept the opinion mentioned above. I submit article 64 of the Contract Law is still made for the benefit of a third party although it does not recognise the third party's power of enforceability. This is because:

1. Although the third party has no right of suit in his own name, he can still enjoy other due rights such as accepting the obligor's performance and sending notice to request the obligor's performance. In normal cases, where the obligor does not break his promise, the third party will get his benefits from the contract.
2. Article 64 does not mean that the third party has no right to recover damages. The correct understanding of it is that the third party can only get recovery

⁹⁷ Liang Huixing, *Study on Interpretation of Private Law*, (1995) p.251, China Zhengfa University Press.

⁹⁸ Yu Yanman, *Study on Contract*, (1999) p.61, Wuhan University Press; Wang Liming & Cui Jianyuan, *New Study on Contract Law*, (2000) p.45, Chinese Zhengfa University Press.

⁹⁹ Ding Chunyan, *The Protection of Third Party's Rights*, in *Law Study's Success*, (2001) p.192, BeiJing University Press.

through the obligee's action. The provision does not deprive the third party's substantive rights for damages but merely denies his direct right to take action.

1.3.1.3 Legal effect to the obligee

Most of the Chinese scholars argued that in a contract for a third party's benefit, the obligee, as a contracting party, should also have the right to enforce those contractual provisions which were made for the third party's benefit. For example, he can send a notice to the obligor to remind him of his performance, and press the obligor to render performance to the third party. But the obligee has no right to accept the performance himself.

Under article 64, only the obligee has the right of action if the obligor fails to perform contractual obligations to the third party beneficiary. However, in the Chinese academic domain, article 64 incurs severe criticism as it disallows the third party to sue on the contract. One opinion holds that a better way to resolve this problem is that *only* the third party has the right of action – the person who suffers loss claims remedies in his own name. The obligee should not have the right to ask for remedies because it will possibly result in injustice if the obligor has liabilities to both the third party and the obligee.¹⁰⁰ Another point of view is that in principle both the third party and the obligee should have the right to ask for remedies in that the third party's right of action is based on contract, while the obligee's right relies on the fact that he is the contracting party.¹⁰¹ In case that both parties sue the obligor for the third party's loss, the court may combine the actions and award damages to the third party only.

¹⁰⁰ Yang Lixin, 'Judicial Practice in dealing with some difficult civil cases' Vol. 2, Jilin Renming Press 1994, 222.

¹⁰¹ Huang Jianrong, 'Study on Contracts for the Benefit of Third Party' Vol. I, Law Press 1994, 19.

Another question is whether the obligee has the right to rescind the contract as he usually can when a third party's right is not involved. There are again two opinions in the Chinese academic domain. One is that the obligee has all contractual rights can exercise freely before the contract ends, whether the contract confers benefits on third party or not.¹⁰² Another opinion holds that the obligee can rescind the contract subject to the permission of the third party, or on the condition that the third party's interests are not damaged.¹⁰³

1.3.1.4 Legal effect to the obligor

It is generally accepted in China that an obligor ought to carry out performance to the third party in accordance with contract terms. It was argued that the third party should have the right of suit, and if he brought an action on the contract, the obligor should have the same defences and set-offs against the third party as he usually had in an obligee's actions.¹⁰⁴ For instance, in an insurance contract an insurer has the right to refuse to pay an insurance indemnity to the third party beneficiary, or he can reduce the amount of indemnity if the insured does not pay off the insurance premiums. It was also pointed out that the contracting parties could expend or limit the range of the obligor's defences by express terms as long as such an agreement would not cause injustice to the third party.¹⁰⁵

The study of a contract for the third party's right is connected to other theories.

¹⁰² Wang Liming & Cui Jianyuan, *New Study on Contract Law*, (2000) p. 27, Chinese Zhengfa University Press; Yang Lixin, *Judicial Practice in Dealing With Some Difficult Civil Cases*, Vol. 2 (1994) p.222, Jilin Renming Press.

¹⁰³ Yang Lixin, *Judicial Practice in Dealing With Some Difficult Civil Cases*, Vol. 2 (1994) p.222, Jilin Renming Press.

¹⁰⁴ Liu Wenhua, *Explanation and Case Study in Chinese New Contract Law*, (1999) p.68, Universal Books Publisher.

¹⁰⁵ Liu Wenhua, *Explanation and Case Study in Chinese New Contract Law*, (1999) p.85, Universal Books Publisher.

1. It is obvious that the law in this field is incomplete and laggard in China to some extent. The theory on third party right is not very clear and it has been muddled with some other legal concepts such as assignment, agency, subrogation and management.¹⁰⁶ In this regard, some authors supported their opinions through comparative research in order to clarify the nature of contracts for third party right.
2. Some other provisions in Chinese Contract Law are also regarded as relevant to third party rights. For example, if contractual obligations and rights belong to the same person in the final analysis, the contract will be regarded as being terminated automatically unless the third party's benefit will be affected.¹⁰⁷ In principle, when one contracting party exercises rights such as rescission of contract, modification of contract and assignment, it is necessary for him to avoid damaging the third party's interests.

1.3.2 Comparative study on rights of third parties

Research on comparative law revealed a great deal of change since the Chinese market economy was established. Especially, it is believed that introduction of western countries' laws helps international business cooperation and economic development. However, comparative study on rights of third parties in China is still limited.

Several articles and books have referred to laws on rights of third parties in other countries, such as England, United States, Germany and France. However, these works were confined to the general introduction and their content was mainly about

¹⁰⁶ As I have mentioned above about nature of the contracts for third party's benefit. The theory of assignment and agency are used respectively to explain the nature of it.

¹⁰⁷ Article 106 of the Chinese Contract Law 1999.

these countries' statutes. Even if some works make comparison, there are few conclusions drawn from them. Secondly, there is less attention on the newly changed laws in the research on rights of third parties. English law has reformed third party rights by promulgating the Contract (Rights of Third Parties) Act in 1999, and thereby established a series of rules on third parties' rights and remedies, contracting parties' rights of modification and cancellation, and the promisor's defences and exceptions. But only a few researchers have introduced it to this analysis.¹⁰⁸

1.4 Experiences from reform of rights of third parties

1.4.1 Precedents for Reform

A factor in support of reforming the third party rule in Chinese law is the fact that both Civil Law systems and Common Law systems recognise enforceable rights of third party beneficiaries under contracts.¹⁰⁹ For example, in Germany, contractual rights for third parties are described under article 328 of the German Civil Code which allows contracting parties to make a contracts for the benefit of third party with the effect that the latter acquires the direct right to demand performance. To what degree third parties can exercise their rights depends on the contractual terms and circumstances of the contracts.¹¹⁰ In France, the general principle that contracts have effect only between the parties to them is qualified by article 1121 of the Civil Code, which permits a stipulation made for a third party's benefit if the person who promises to render performance to the third party simultaneously promises something to the other contractor as well, or if the contracting party makes the promisor some gift in

¹⁰⁸ Yang Liangyi, *Rule of International Business---English Contract Laws Revision*, (2000), China Zhengfa University Press; Ding Chunyan, "The Protection of Third Party's Rights" in *Law Study's Success*, (2001), BeiJing University Press.

¹⁰⁹ K.Zweigert & H.Kotz, *An Introduction to Comparative Law*, 3rd Edition, p.462, Clarendon Press.

¹¹⁰ Consultation Paper No 121, Appendix paras 28-29

connection with the transaction. This was interpreted by the French courts as permitting the creation of an enforceable stipulation for a person in whose welfare the stipulator has a moral interest.¹¹¹ However, application of this article has been extended so that contracts for third parties benefits will take effect even if the above requirements are not satisfied. The performance which the promisee must make to the promisor under article 1121 needs no longer to be a gift: any economic transfer will suffice, and the alternative requirement of the Code, that the promisee must always stipulate something for himself at the time of contract, has been understood by the courts as being satisfied if any *profit moral* accrues to him as a result of transaction.¹¹²

In the United States, *Lawrence v Fox*¹¹³ was the first case recognising that a third party has the right of enforcement in the contract in his favor. In 1931, the first Restatement of Contracts endowed enforceable rights only to a “donee beneficiary” or an “obligee beneficiary”.¹¹⁴ The second Restatement of Contracts (1981) modified this and distinguished an “intended beneficiary” from an “incidental beneficiary” in section 302; and only an intended beneficiary has the right to enforce the contract. In Western Australia and New Zealand, legislative reform of the privity doctrine appeared in the 1960s and the 1980s. Section 11 of the Western Australian Property Law Act 1969 provides that: “...where a contract expressly in its terms purports to confer a benefit directly on a person who is not named as a party to the contract, the contract is ...enforceable by that person in his own name ”.¹¹⁵ The New Zealand Contracts (Privity) Act Section 4 states that: “deeds or contracts for the benefit of third parties – where a promise contained in a deed or contract confers, or purports to confer, a benefit on a person, designated by name, description, or reference to a class, who is not a party to the deed or contract (whether or not the person is in existence at the time when the deed or contract is made), the promisor shall be under

¹¹¹ Law Commission No 242. Para. 3.8

¹¹² K.Zweigert & H.Kotz, An Introduction to Comparative Law, 3rd Edition, p.463, Clarendon Press.

¹¹³ 20 NY 268 (1859)

¹¹⁴ Section 133 of First Restatement of Contracts.

¹¹⁵ W Austr Acts 1969, No32.

*an obligation, enforceable at the suit of that person, to perform that promise.*¹¹⁶ The Act provides definitions of benefit, beneficiary, contract, court, promisee and promisor in section 1. It also establishes the test for defining the scope of third parties,¹¹⁷ fixes the scope of remedies which are available to a third party including damages, specific performance and injunction,¹¹⁸ and also sets up the rules on a promisor's defences.¹¹⁹

Reviewing the countries in the European Union, the laws of Germany, France, Italy,¹²⁰ Austria,¹²¹ Spain,¹²² Portugal,¹²³ Netherlands,¹²⁴ Belgium,¹²⁵ Luxembourg,¹²⁶ Greece and Scotland¹²⁷ recognise rights of third parties in the contracts. The Principles of European Contract Law also accept such rights by providing that "a third party may require performance of a contractual obligation when his right to do so has been expressly agreed between the promisor and the promisee, or when such an agreement is to be inferred from the purpose of the contract or the circumstances of the case. The third party need not be identified at the time the agreement is concluded."¹²⁸

In England, the 1999 Act reforms the privity rule by allowing third party beneficiaries to enforce contracts when the contracts expressly provide that they may, or when a term purports to confer a benefit on him. If on a proper construction of the

¹¹⁶ New Zealand Contract (privity) Act 1982. See: www.rangi-knowledge-basket.co.nz/gpacts/public/text/1982 30 Oct 2002

¹¹⁷ Section 4 of New Zealand Contract (privity) Act 1982.

¹¹⁸ Section 8 of New Zealand Contract (privity) Act 1982.

¹¹⁹ Section 9 of New Zealand Contract (privity) Act 1982.

¹²⁰ Article 1411, Italian Civil Code 1942

¹²¹ Article 881. Austrian Civil Code 1811

¹²² Article 1257 par2, Spanish Civil Code 1889

¹²³ Article 443, Portuguese Civil Code 1966

¹²⁴ Book 6 article 253, Dutch Civil Code 1992

¹²⁵ International Encyclopedia of Comparative law (ed Kotz), Vol VII, ch 13, para 13-12

¹²⁶ International Encyclopedia of Comparative law (ed Kotz), Vol VII, ch 13, para 13-12

¹²⁷ The Laws of Scotland Stair Memorial Encyclopaedia, Volume 15 (1996), 533

¹²⁸ Article 6:110, Principles of European Contract Law.

contract, it appears that the parties did not intend the terms to be enforceable by the third party, the third party will not have such a right.

In this thesis, English Law is used as a major comparator system rather than other legal systems including those which are geographically close to China because:

1. English law reform will be very helpful as a guidance to the Chinese reform. It is the most recent statutory development in relation to the rights of third parties. The privity reform in England was based on the large amounts of research, judicial practice and review of experiences from other countries' laws. Comparatively, the English 1999 Act is the most comprehensive treatment of the subject in a legal text. It designed a framework for all manner of issues, including a test for third party enforceability, contracting parties' rights of variation and cancellation, promisors' defences, overlapping claims, third party's remedies and the status of the existing exceptions to the privity doctrine. This provides a comprehensive guidance for the Chinese Contract Law reform.
2. Parallel to the situations before the English 1999 Act, the English law and Chinese law traditionally stuck to the privity doctrine although in both countries the reform had been called on for a period of time. Originally English Law was a strong version of privity just like Chinese Law is. The problems caused by the privity doctrine and the reasons to reform have been probed in England for many years. These problems also exist in China now such as prejudice of contracting parties' freedom of contract, injustice to the third party beneficiary and black hole problem. The same reasons to reform privity have been described in the Chinese academic domain.¹²⁹

¹²⁹ Liu Yuhui, "Some Problems of Rights of Third Parties", (2002) issue no.2, Journal of Jiangxi Agricultural University (Social Science Edition) at 75; Wang Qiuliang & Cai Donghui, "On Contracts for Third Party Right and Methodology", (2003) Journal of Shanghai Institute of Politics and Law,

1.4.2 Value of comparative study to Chinese Contract Law

Comparative study can be helpful to the third party rule reform in China.

First, many issues which Chinese contract law faces in recognising the rights of third parties beyond privity have already been identified and addressed in other countries' laws. For example, the theoretical basis explaining third parties' enforceable rights have been largely illustrated in other countries. These theories include contracting parties' intention, the purpose of the contract, nature of the transaction, network or group contracts, third parties' special interests and cases with particular facts. There are different solutions to extend the promisor's obligation beyond privity in different countries such as contracts for the benefit of third parties, contracts with protective effect on the third parties, an approach through the law of tort and the establishment of specific legislation.

Secondly, in order to prevent circumvention of privity of contract, the Chinese courts, in cases such as *Huanqiu Company v Guoyin Mang City Farm*,¹³⁰ *Qingdao Third Shoe Factory v. Chinese International Trade Corporation*,¹³¹ have supported the obligees' claims for substantial damages although it was the third parties who suffered loss. The decisions, therefore, broke another rule that the plaintiff can claim substantial damages only for his own loss. Comparative study from other countries' experience showed that there are other better solutions to solve the problems. The solutions to the so-called "black hole" problem – where the promisee has a right of action but suffers no loss, whereas the third party suffers loss but has no right of action - have been discussed for a long time in English law. Its theoretical basis and

issue no. 1, 39; Han Shiyuan, 'A Tentative Study on Contract for Third Party Right', (2004) Legal Science, issue no. 6, 54

¹³⁰ Li Guoguang, *Typical Cases in Chinese Civil Law and Commercial Law*, (2004), pp.70-80, People's Court Press.

¹³¹ Li Guoguang, *Review and Comments on Typical Cases*, (2003) pp.89-101, People's Court Press.

legal thinking point the way towards how the extension of contractual liability beyond privity reconciles with the contractual principles. It will be argued that an effective approach to be adopted in Chinese Law is to develop true exceptions to the privity doctrine.

Thirdly, the different countries' experiences to deal with third parties' rights show that solutions could be flexible and applicable if they are based on different techniques or concepts. For example, German law has resorted to parties' true intentions, the objective purpose of the transaction or the contract with protective effect, to extend the scope of third party right beyond privity. In French law, apart from genuine contracts for the benefit of third parties, the more successful exceptions to privity of contract have been those which attach to particular contracts by reason of their types.¹³² In English law, the combination of parties' intention and existing exceptions to privity enable the courts to extend contractual liability beyond privity according to the particular facts of cases even in the absence of specific party intention. Under some circumstances, the principle of justice may be applied directly to create exceptions to privity if the facts of cases or nature of the transaction require it.¹³³ However, before introducing other countries' experience, the Chinese courts should look at the practicability as well as constitutional restrictions on their discretion.

Finally, some special statutes in China have extended contractual obligation beyond privity on the grounds of particular types of contracts and nature of the transactions, although under article 64 of the Chinese Contract Law, the obligor's liability for breach of contract is limited to the obligee. Besides those contracts in which third party beneficiaries' rights are generally recognised, such as insurance

¹³² Simon Whittaker, "Privity of Contract and the Tort of Negligence: Future Directions", (1996) 191, *OxJLS* at 193.

¹³³ B Coote, "The Performance Interest, Panatown and the Problem of Loss", (2001) 117 *LQR*, at 81

contracts¹³⁴ and bills of lading,¹³⁵ the subcontractor's liabilities are extended to the employers under article 272 of the 1999 Chinese Contract Law, which states:

With the consent of the contract letting party, the general contractor or the contractors for survey, design or construction may assign part of the contracted work to a third party. The third party shall assume joint and several liabilities to the contract letting party together with the general contractor or the contractors for survey, design or construction in respect of its work achievements. A contractor may not assign the whole contracted project to a third party or divide the whole contracted construction project into several parts and assign them respectively to third parties in the name of subletting.

The contractors' liabilities for quality of construction extend to subsequent owners or occupiers within the guarantee period under article 4 of the Chinese Construction Quality Guarantee Regulation,¹³⁶ and the contractor bears liability to compensate for physical injury or property damage of the subsequent owners, occupiers or other people who use the property under article 14.

¹³⁴ Article 21 of the 1995 Chinese Insurance Law: "Beneficiary" shall mean a person, designated by the Insured or the Applicant in the life insurance contract, who is entitled to make a claim for payment. The Applicant or the Insured may be the Beneficiary.

¹³⁵ Article 83, Chinese Maritime Law 1992

¹³⁶ Chinese Construction Quality Guarantee Regulation was promulgated by Ministry of Works in 2000.

CHAPTER 2

BASIC THEORY OF THIRD PARTY RIGHTS

2.1 Role of the privity doctrine in China

2.1.1 Origin of the privity doctrine in China

As a fundamental principle in the Chinese contract laws, the doctrine of privity, also named as the principle of contractual relativity, is introduced from the Civil Law systems. It requires that a contract take legal effect between the parties who make it and agree to comply with it only, and other people can neither enjoy rights nor bear liability created by the contract. This principle holds a stable position in the Chinese traditional contractual regulations since *Draft Civil Code of the Great Qing* was completed in 1910. How was the privity doctrine established? What was the source the privity doctrine? Why does it play a fundamental role in Chinese contract laws? I will answer these questions with the following three points:

1. It is generally accepted in China that the privity doctrine originates from legal concept of *obligation*. Obligation arises from parties' agreements or directly from statutes and it only takes effect among those people who make the agreements. This is the fundamental principle in the Chinese

Civil Code.¹³⁷ It also explains why the obligation is also called relative right.¹³⁸ By contrast, another kind of right – right to things, directly arises from the laws, and the right holder is entitled to claim against anyone who damages that right. The main characteristic of the contract law is the contract law only regulates the particular relationship based on the common intentions of certain people, viz. the contractual relationship between the contracting parties, while the law of *rights over things* is not limited within any specific relationship. This is the reason why the contract law is regarded as an independent part of the Chinese Civil Code and distinguishes itself from the law on *rights over things*.¹³⁹

2. The privity doctrine originates from freedom of contract. The concept of freedom of contract is explained from two aspects. One is that any contract is made by the parties according to their own wills, and all the rights and obligations arising from the contract are inviolable and must be executed by the law and courts. Another is that any contract has binding force on the contracting parties. The nature of the Chinese contract is private law, which regulates transactions between equal parties who are doing their business in a free and fair-trading market. The contract law therefore aims to smooth each transaction, protect private individuals' interests and help to realize their business purposes. One of the most important ways to protect private parties' interests is to guarantee their freedom in entering

¹³⁷ Article 84 of the 1986 Chinese Civil Code provides: "According to agreements made in contracts or legal regulations, obligatory relationship is produced among certain parties. The party who has rights is an 'obligee' and the party who bears responsibility is an 'obligor'. Only obligee is entitled to ask the obligor for performance of the latter's contractual liabilities."

¹³⁸ The right is so called because it can be claimed only by certain people against other particular people. See Wang Jiafu "Obligations of Civil Law", Publishing House of Law (1991), p. 8. Shi Shangkuan: "Comprehensive Review of the Obligation", Jilin University Press, p. 198.

¹³⁹ Contract Law and Law relating to rights over things are two important parts in Chinese Civil Law. The theoretical basis of the division is the specified civil relation between certain people and uncertain civil relation between unspecified people.

their contracts, including with whom they choose to cooperate, how to make an agreement and what the agreement is about.

3. The privity doctrine is thought natural and logical coming from the legal conception of “contract” in China. A contract is an agreement between the parties which shows their common intentions and purposes. Therefore, the contract is binding on parties who sign it but nothing to do with other people. This means no person except contracting parties can enjoy contractual rights or fulfill contractual obligations. This principle is strictly maintained so that even under the circumstances where contracting parties purport to confer a benefit on a third person, the third person’s rights such as the rights to request, remind or press the obligor to fulfil his obligations during the performance of the contract, which are impliedly recognised by the Contract Law, is not actual “contractual rights” but merely pure benefits arising from contract.¹⁴⁰ Contractual rights are those enforceable rights which are expressly described in the contract by the contracting parties or directly provided by the law. The reason why a third person’s rights to request or remind the obligor to perform the contract is not called *contractual right* but merely as *benefit* is because these third person’s rights are not enforceable rights: where the third person cannot get the benefits as a result of the obligee’s breach of contract, the only way for the third party to claim is to depend on the contracting party’s action, and any direct claim on the contract will be rejected by a court.

2.1.2 Embodiment of the privity doctrine in Chinese Statutes

No provision directly provides the privity doctrine in the Chinese Civil Law or the

¹⁴⁰ Wang Jiafu, ‘Obligation – The Chinese Civil Law’, Law Press (1991), 15

previous contract laws - ECL, FECL and TCL, but it was indirectly reflected in some regulations. The privity doctrine was not emphasised before 1986 because it followed from the legal conception of 'contract', the purposes of contract laws. At the stage when ECL, FECL and TCL were promulgated, contracts were made by parties upon their agreement to realise their expectations, but a more important function of contract laws was to realize the state's plans. Under the three contract laws, the state owned prior power to intervene in transactions between contracting parties or change their contracting rights or obligations according to the state's plan and requirements.

On the other hand, the requirement that contracts take legal effect only between contracting parties is embodied in some particular provisions about assignment and subrogation. According to article 91 of the Chinese Civil Law, one contracting party cannot assign whole or part of his contractual rights or obligations to a third party without another contracting party's consent. Article 19 of the ECL 1981 provided that the contractor cannot assign his contractual obligations to a third party without the agreement of the employer. Also a tenant under a lease should acquire the lessor's permission before he assigns his contractual rights to a third party under article 23. Article 25 prescribed that where an the insured property is damaged as the result of a third party's fault, the insured has the right to ask the insurer for compensation. Then the insurer gets subrogation against the third party under the contract instead. These provisions accord with one of the requirements of the privity doctrine - the contracting parties are specified in a certain contract and all contracting rights and obligations take legal effect between them only.¹⁴¹

The privity doctrine attracted more attention after a free market system was gradually established since 1979 and freedom of contract became one the most

¹⁴¹ Cui Jianyuan & Han Shiyuan: "The Theory of Subrogation in the Chinese Contract Law", <http://www.civillaw.com.cn/lawfore/CONTENT.ASP?programid=1&id=166> 16 Feb 2003; Cheng Xiao "On Subrogation and Lawsuit of Subrogation", <http://www.civillaw.com.cn/lawfore/CONTENT.ASP?programid=4&id=28> 16 Feb 2003

important principles in contract laws.

Rules on contract privity were directly set down in the 1999 Chinese Contract Law. Article 121 provided that where an obligor fails to fulfill his contractual obligations because of a third party's fault, the obligor is still responsible for breach of contract to the obligee. But the obligor is entitled to bring another action independently against the third party. Under article 65, where contracting parties agree in their contract that a third party should make a performance to the obligee, the obligor owes liabilities for breach of contract to the obligee if the third party fails to complete performance. Article 64 prescribes that where a third party should get benefit from the obligor's performance according to the contract terms, if the obligor fails to accomplish performance, the obligor owes liability for breach of contract to the obligee instead of to the third party. This article explicitly denies that the third party has the right to sue the obligor based on the contract.

The above provisions satisfy the requirements of the privity doctrine – only an obligee has the right to bring an action against the obligor relying on the contract. Therefore, in a case where an employer A sold a building to C while contractor B bears the liability to complete the construction work, A must be responsible to C if B fails to fulfil his performance satisfactorily. On the other hand, even if A and B agree that B must be liable to C who would become the prospective building owner, B still has to take liability for breach of contract to A. Under article 121, A, in no case, can exempt his liability to C whether he has fault or not.

2.1.3 Application of the privity doctrine in Chinese judicial practice

In China, when dealing with the cases, the courts have to decide first whether a plaintiff is the right person who is entitled to sue. This requires any person who intends to bring an action must be qualified to be a plaintiff. The privity doctrine is normally applied in an action based on a contract, so the only person who is entitled



to sue is a party who has a contractual relationship with the person whom he is against.

The argument arose in a case decided in 2003, *Wangjun v Vehicular Parking Station* which concerned whether the plaintiff had the right to bring an action. In July 2002, Zhangyi and Wangjun made an agreement that Zhangyi invested 20,0000 yuan to buy a truck in the name of Wangjun. They agreed that Wangjun would be the owner of truck legally but be responsible for register, license and insurance in return for 500 yuan commission, while Zhangyi owned a right to use the truck permanently. During using the truck for business, Zhangyi always left his car in Vehicular Parking Station. However in January 2004 it was stolen. Vehicular Parking Station refused to answer for it. Then Wangjun, at Zhangyi's request, brought an action against Vehicular Parking Station. The court considered Zhangyi was the person who consigned the truck to Vehicular Parking Station and paid the parking fee. In addition, Zhangyi was not an employee of Wangjun, therefore Zhangyi's act in entering into the contract with Vehicular Parking Station was not on behalf of Wangjun. Although Wangjun was the owner of the truck, he had no contractual relationship with Vehicular Parking Station. Since the plaintiff's claim against Vehicular Parking Station was based on the contract, according to the privity doctrine, Zhangyi was the only person who was qualified for contractual remedies. The court then dismissed Wangjun's claim.

2.1.3.1 Contracts of Sale

Many contracts of sale involve contractual chains. The typical case is where A sells goods to B, and B then sells it to C. Normally each party enjoys rights and perform contractual obligations according to the terms in their own contract, and they are confined to claims against their direct contractual parties. Therefore, C is unable to claim damages directly from A if the goods are found defective, or if B's delivery of the goods is delayed because of A's fault. Neither is A able to claim payment directly

from C, even B failed to pay for the goods. There are many cases where C was denied an action on the grounds that B is the only person entitled to bring the action.

The privity doctrine was emphasised again in *Shandong Labour Service Company v Zonghe Company and Shandong Economic Development Center*.¹⁴² The facts involved a series of agreements for the sale of buildings between 6 parties. In 1991, Shandong Economic Development Center (SEDC) entered into the contract with a local council for investment on the construction of several buildings. Before construction was finished, SEDC sold the building to Shiye Company (SC) and Shangdong Technology Development Company (TDC). During this time SEDC did not apply for the licence to transfer the right of using land. But according to the Regulations on Land Administration About Transferring Rights of Use of Land,¹⁴³ only after the building owner gets a license, can ownership of the building be transferred.¹⁴⁴ Three months later, with the approval of TDC, SC entered into the contract with Zonghe Company to sell the buildings to the latter. Due to a change of plan, Zonghe Company (ZC) contracted with Shandong Labour Service Company (LSC) to sell the buildings. LSC paid the price, but the buildings remained uncompleted 6 months after the agreed deadline. Later, LSC came to know that non-completion of buildings was caused by SEDC's non-payment. LSC then brought an action against both Zonghe Company and SEDC. The court held that SEDC owed no contractual duty to LSC. In chains of contracts for sale, only parties who have contractual relationships are entitled to claim damages against each other. In this case, SEDC sold buildings without the necessary licence, so the contract between SEDC, SC and TDC took no legal effect. SEDC should return the contract price to SC and TDC, and also compensate their loss caused by the invalid contract. In addition, both the contract between SC and ZC, and the contract between ZC and LSC were invalid.

¹⁴² The case was decided in 1994, Report of Judicial Cases, Renmin University Press (1996), 109

¹⁴³ The Regulations on Land Administration About Transferring Rights of Use of Land was promulgated in 1990

¹⁴⁴ Article 8, 19 and 21

The sellers should return the contract price to the buyers and compensate the buyers' loss caused by the invalid contracts. The scope of recovery and damages or liquidated damages is differently applied according to their own contract terms.

In *Wuxian Gongxiao Company v Xiamen Jiada Company*,¹⁴⁵ the defendant promised to sell sets of machines to the plaintiff in 1991. In order to perform the contract, later the defendant ordered the machines by making a contract with Tongjiang Import and Export Company. Tongjiang Company failed to supply the goods before the delivery time, which caused the defendant unable to carry out his promise to the plaintiff. The Intermediate Court in Suzhou City considered that Tongjiang Company was the only party at fault, so they added Tongjiang Company as co-defendant. The decision was repealed by the Superior Court in Jiangsu Province because the two contracts concerned two independent contractual relationships which should be dealt with separately. Tongjiang Company's non-delivery of the goods and the fact that the Xiamen Jiada Company had no fault could not exempt the latter's liability for breach of contract to the plaintiff.

In case *Longxingtai Company v Huayue Company*,¹⁴⁶ the plaintiff contracted with the defendant to purchase imported lifts. In the contract, Longxingtai Company promised to pay 5 percent of the contract price in advance as deposit, and they also made an agreement that Huayue Company should return double value of the deposit if it failed to supply the goods according to the contract terms. After the contract was made, Huayue Company entered into another contract with Shanghai Mitsu Company to order lifts. Later Shanghai Mitsu Company supplied a different model lifts. As Huayue Company failed to supply the goods on time, LongXingtai Company claimed for the double deposit back. Huayue Company defended by reason that its failure to carry out the promise was caused by Shanghai Mitsu Company, so it should not take

¹⁴⁵ Gao Yuanwen, Study on Civil Cases – Contract For Sale', (1999) Keji Press, 221

¹⁴⁶ The case was decided in 1998 in the trial of instance and decided in 2002 by the court of appeal <http://www.ccmt.org.cn/ss/news/show.php?cId=950>, December 19, 2004

responsibility because it had no fault. Some disputes arose about whether Shanghai Mistu should be added as co-defendant and compensate the value of the double deposit to the plaintiff. Both the decision at first instance and in the court of appeal denied that Shanghai Mistu Company owed any liability to Longxingtai Company. Huayue Company, as the debtor of the contract, was the only person who was responsible for returning double deposit to Longxingtai Company. According to the Chinese Supreme Court's Reply on Damages of Deposit,¹⁴⁷ in chains of contracts of sale, one contracting party who failed to carry out his performance because of a third party's fault (a supplier in another contract), still owes liabilities to return a deposit to the plaintiff according to the contract terms, but the contracting party is entitled to recover his loss from the third party. Therefore, Huayue was able to claim the value of the double deposit from Shanghai Mistu Company in a separate action.

The above cases show application of privity doctrine by Chinese courts.

2.1.3.2 Lease Contracts

Chinese Law allows lessees in lease contracts to sublet the subject matter of the contract to third parties with lessors' permission in advance or lessors' ratification afterwards. The law relating to the operation of sublets is part of Chinese contract law, which means privity of contract is also applied – the parties only enjoy contractual rights and perform contractual obligations according to the terms of their own contract. Under article 224 of the Chinese Contract Law, contracts between lessors and lessees continue to be effective after the lessees sublet the subject-matter to third parties; where third parties damage it, the lessees owe liability to compensate the lessors' loss.

The same rule is reconfirmed in the Regulation On Lease of City Buildings

¹⁴⁷ The Chinese Supreme People's Court, (1995) No. 76

which provides:¹⁴⁸

After contracts between lessees and sublessees take legal effect, lessees, who are in the position of lessors in the sublease contracts, enjoy the benefits promised from sublessees accordingly. But, on the other hand, they shall carry out contractual obligations established in the contracts with lessors independently, unless the parties make a different agreement.

In *Lv Shiyou v Chen Sheng*,¹⁴⁹ Lv Shiyou promised to rent his house to Chen Sheng for three years, and got promise from Chen Sheng to pay 500 yuan per month in return. Three months after Cheng Sheng moved in, Lao Xiang asked Chen Sheng for a renting the house and promised to pay 1,000 yuan per month. Then Cheng Sheng sublet the house to Lao Xiang. Without permission from Chen Sheng or Lv Shiyou, Lao Xiang opened a door in one of the rooms facing the street, used the house as a shop and began to do business. Lv Shiyou found out later and claimed compensation from Chen Sheng and Lao Xiang. The court held the contract between Chen Sheng and Lao Xiang was invalid because Chen Sheng's sub-let did not get approval from the plaintiff. As Lao Xiang changed the house without the owner's permission and therefore caused loss to the latter, the owner therefore hadt the right to claim damages from Chen Sheng and rescind the headlease.

The similar decision was made in *Zeng Mou v Wang Xuehua & Sang Jun*¹⁵⁰ in 2000. Zeng Mou contracted with Wang Xuehua to rent a flat to the latter. After half a year, Wang Xuehua's request to let his friend, Sang Jun, occupy one bedroom got Zeng Mou's permission. Later Zeng Mou found that Wang Xuehua actually rented the whole flat to Sang Jun, and Sang Jun broke out a wall between one bedroom and balcony in order to enlarge the room. Sang Mou brought an action against Wang Xuehua and Sanghua for recovery of damages from Sang Jun, termination of the

¹⁴⁸ Article 30, the Regulation On Lease of City Building

¹⁴⁹ *Lv Shiyou v Chen Sheng* Was decided in 1998, Jin Pengnian, Case Study and Comments – Lease Contract', Intellectual Property Press, 82

¹⁵⁰ Fang Shaokun, Study on Typical Real Estate Cases, the Proples Court Press (2002), p145

contract with Wang Xuehua and compensation from Wang Xuehua for his breach of contract. The court held that Wang Xuehua should pay the value of renovation of the flat to Zeng Mou, and also to pay Zeng Mou liquidated damages for breach of contract.

*Tongda Company v Tian Kun*¹⁵¹ concerned the lease of automobile carriers. In January 1998, in order to engage in a freight business, Tian Kun entered into a contract with Tongda Company to hire two five-ton load motor lorries for two years. Six months later, Tian Kun found only small profits in the freight business, so he sub-let the lorries to Zhao Shunchang. Tian Kun informed Tongda Company about the sub-let by telephone, and Tongda did not object expressly. In October 1998, one of the lorries was seriously damaged in an accident. Tongda Company brought an action and alleged that the sub-let was invalid and Tian Kun should take responsibility for breach of contract. Tongda's claim for invalidity of its contract with Tian Kun was denied by the court on the ground that it had approved Tian Kun's sublet by acquiescence. But its claim for damages of the lorry from Tian Kun was supported. The court held that Tongda Company, Tian Kun and Zhao Shunchang remained liable for breach of terms of their own contract.

The decisions of the above cases show that the privity doctrine is strictly applied in lease contract chains. The effect of its application can be briefly explained in the following four points:

1. The original lessee and lessor remain liable for breach of terms in the lease despite the sublet. The lessor and the sub-lessee owe no contractual duty to each other.
2. The original lessee's right to sublet is based on the validity of the headlease

¹⁵¹ *Tongda Company v Tian Kun* Was decided in 2001

<http://www.hflib.gov.cn/law/law/falvfagui2/msf/JDAL/1157.htm>, Mar5, 2005

and permission of the lessor. Where his right ends because of termination of the headlease or other reasons provided by the law, the original lessee has the right to sublet.

3. The sub-lessee is only able to enjoy rights established in the contract with the sub-lessor. The sublessee's rights in the contract with the original lessee do not affect the lessor's rights. The original lessee owes liabilities to the sub-lessee for breach of contract where it is the lessor's fault leads to end of the head-lease.
4. Where a sub-lessee's rights are infringed and it suffers loss because the original lessee's sublet without permission of the lessor, the original lessee owes liabilities for the sub-lessee's loss.

2.1.3.3 Contracts for Financial Lease

In a financial lease contract, the lessor lends the equipment to the lessee for profits from rent, and is responsible for purchasing the equipment from a supplier under the lessee's requirements. Generally speaking, there are three parties joining in a contractual chain of financial lease – a lessor, a lessee and the supplier. The Chinese laws keep each party's rights and obligations within the terms of their own contracts. Under article 12 of the Regulations On Judgment of Cases Concerning Contracts For Financial Lease,¹⁵² where the supplier fails to complete his promise about quality of goods, quantity of goods or delivery on time, only the lessor is entitled to claim for remedies based on the contract for sale. But this rule is subject to an exception where the three parties all agree on assignment of the right of claim from the lessor to the lessee. Article 240 of the Contract Law prescribes that the lessor, seller and lessee may agree that, where the seller fails to perform obligations in the contract for sale,

¹⁵² Regulations On Judgment of Cases Concerning Contracts For Financial Lease was promulgated by the Chinese Supreme People's Court in 1996

the lessee shall exercise the right of claims. Where the lessee exercises the right, the lessor shall provide assistance.

*Huaqiao Farm (appellee) v Huanqiu Company (appellant)*¹⁵³ was decided by the Chinese Supreme Court in 1995. Huaqiao Farm, for the purpose of financing, entered into the contract with Huanqiu Company. They agreed that Huanqiu Company would purchase income-producing equipment under Huaqiao Farm's requirements and rent them to Huaqiao for 10 years. After that Huanqiu Company contracted with Sanyang Company. Huaqiao Farm joined in the negotiation of the contract and stated the requirements of the goods. Later it was proved that the goods were defective. Huaqiao Farm brought an action against Huanqiu Company for remedies. Huanqiu Company defended on the ground that according to its contract with Huaqiao Farm, they agreed on assignment of the claim from the defendant to the plaintiff, which meant Huaqiao Farm could claim damages directly from Sanyang Company, and Huanqiu Company did not take responsibility for defective goods. The courts, basing themselves on article 91 of the Chinese Civil Law,¹⁵⁴ held that the contract term on assignment of claim for damages from Huanqiu Company to Huaqiao Farm was invalid without the permission of Sanyang Company. Therefore, the defendant owed liabilities for defective goods to Huaqiao Farm, and Sanyang Company owed liability for breach of the contract to Huanqiu Company.

A similar decision was made in 1996 in *City Spinning Mill v Huayang Financing Company*.¹⁵⁵ Huayang Financing Company contracted with City Spinning Mill to purchase sets of equipment and rent them to the latter. Huayang Financing Company entered into another contract with Youli Company to acquire the equipment. Both contracts provided that City Spinning Mill had the right to claim for damages directly

¹⁵³ Jin Pengnian, Case Study and Comments – Financial Lease Contract, (1999) Intellectual Property Press, p196

¹⁵⁴ Article 91 of the Chinese Civil Law provides that one contracting party shall get another contracting party's permission to assign his part or whole contractual rights or contractual obligations.

¹⁵⁵ Zhao yuyuan, Typical Cases Study and Analysis, (1999) Keji Press, p55

from Hong Kong Youli Company for the latter's breach of contract. Later Youli Company failed to perform the contract satisfactorily. City Spinning's right of action against Youli Company was denied by the court on the ground of regulations on international business.¹⁵⁶ The court held that City Spinning Mill, Huangyang Financing Company and Youli company remained liable only for breach of terms of their own contracts.

Under the 1999 Chinese Contract Law, application of the privity doctrine is subject to particular facts of cases. This point will be discussed in the 2.2 below.

2.1.3.4 Contracts for Work

Under article 253 of the 1999 Chinese Contract Law, where a contractor assigns the contracted work to a third party, he shall be liable to the ordering party for the work results. Under article 255, the contractor may assign some auxiliary work to a third party, in this case the contractor shall be responsible to the ordering party for the work results completed by a third party. Both provisions show that the privity doctrine is applied in contracts and sub-contracts for work.

In *Zhongtian Science and Technology Company v Lantian Company*,¹⁵⁷ Zhongtian Company contracted with Lantian Company for processing and installing doors and windows of an office building. Later Lantian sub-contracted the work to Jiahe Company. The work was found defective because Jiahe Company used material of inferior quality. The Court held that Jiahe Company owed no liability for breach of contract to Zhongtian Company, but Zhongtian Company was entitled to recover the

¹⁵⁶ Only the Chinese companies with the permit of international business were able to do transactions with overseas companies and enjoy all the rights arising from the transaction according to the Chinese Regulations on International business (1991). The rule was abolished in 1999.

¹⁵⁷ *Zhongtian Science and Technology Company v Lantian Company* was decided in 1999, Zhu Mingshan, *Typical Cases and Application of Statutes – Contracts for Work*, (2004) Fazhi Press, 174

loss from Lantian Company.

2.1.3.5 Contract of Storage

It is recognised that the essence of safekeeping is exclusive because the keeper's tasks are based on his client's trust. This indicates that privity between the keeper and his clients is especially highlighted by the law. The 1999 Contract Law prohibits the keeper from sub-contracting the work of safekeeping to a third party, unless the keeper and his clients make an agreement on it. However, whether the keeper sub-contracts with the agreement of his clients or not, the keeper remains liable for any loss or damage to the equipment.¹⁵⁸

In *Zhang Shan v Nanfang Hotel*,¹⁵⁹ a contract was made between Nanfang Hotel and Zhang Shan. Zhan Shan should pay 500 yuan in return of the Hotel's promise to store the auticycle. Due to limited parking space, the Hotel passed the auticycle to Yang Lu for safekeeping. Later Yang Lu used it without consent and damaged it in an accident. Zhang Shan sued against Nanfang Hotel for recovery of the loss. His claim was supported by the court – Nanfang Hotel should be responsible for the loss of auticycle to Zhang Shan who entered into the contract with it.

2.2 Exceptions to the privity doctrine in China

The privity doctrine in Chinese Contract Law is deeply rooted in Chinese contract laws and in learners' studies as well. We can also find the explicit and detailed expression which confirmed the basic status of this doctrine in many textbooks about

¹⁵⁸ Article 371 of the 1999 Chinese Contract law

¹⁵⁹ Liu Wenhua, Rules of the 1999 Contract And Typical Cases, (1999) The World Book Press (1999)

the basic theory of Chinese Civil Law and Contract Law.¹⁶⁰ However, my purpose is not to canvass more specific details of the privity doctrine which have been discussed in the Chapter one. Instead, the central thrust in this part is about how Chinese law has made progress in dealing with third parties' rights and what approaches the Chinese courts use in judicial practice to avoid unsatisfactory results by applying the privity doctrine. I will then compare other countries' approaches.

The privity rule was formally established in the 1993 Contract Law Revision and reconfirmed in the 1999 Contract Law. In spite of a large amount of provisions and cases favouring the privity doctrine, there are some other cases which exclude application of the privity doctrine. These cases were decided on the basis of fundamental principles or some theories established in the Chinese contract laws and specific laws.

2.2.1 Creating exceptions to the privity doctrine by way of basic principles

Where sticking to the privity doctrine results in prejudice of other fundamental principles, the Chinese courts have avoided application of the privity doctrine, and replace it with the application of other principles such as freedom of contract, honesty and trustworthiness and justice.

1. With the new market-economy policy established in 1979, the legal concepts have changed dramatically. Chinese contract laws became powerful instruments to smooth economic activities among natural persons, legal persons and other organizations, to protect their lawful rights and

¹⁶⁰ Wang Liming & Cui Jianyuan, *New Study on Contract Law*, (2000) China Zhengfa University Press, p.27; Wang Jiafu, *Obligation in the Chinese Civil Law*, (1991) Law Press, p.4; Wang Liming, *On Privity Principle*, (1996) China Legal Study, also see <http://www.civillaw.com.cn/lawfore/CONTENT.ASP?programid=1&id=36> Feb 15 2003; Liu Wenhua, *Explanation and Case Study in Chinese New Contract Law*, (1999) Universal Books Publisher, p.91;

realize their expectations in entering into these activities.¹⁶¹ Therefore, under the contract laws every party has an equal status and everyone has freedom to decide his own matters for himself. On the other hand, the contract laws are required to balance every party's interests so as to realize equality and justice. This determines that the principle of freedom of contract, the honesty and trustworthiness principle and the principle of justice function more important than the privity doctrine does.

2. According to the Chinese law, the principles should be directly applied and as the basis of the courts' decisions. What principle and to what degree the principle should be applied, depends on the facts of cases. Where there is no appropriate provision to be applied to decide the case, the principles are applied at the courts' discretion. The principle of justice and the principle of honesty and trustworthiness are emphasised in article 6 of the 1993 Draft of Chinese Contract Law¹⁶²: *"The courts are entitled to apply the principle of honesty and trustworthiness directly where there is no appropriate regulation to be applied, or the application of some related regulations will definitely leads to injustice."*¹⁶³ Professor Jiang Pin urged that, in order to solve the conflicts arising from applying several principles and provisions in the same case and avoid some "legal but not rightful" circumstances to happen, it is necessary for the courts to apply the principle of honesty and trustworthiness and the principle of justice to deal with various different

¹⁶¹ Article 1 of ECL 1981 explained that the aim of the law was to protect all parties' lawful rights, improve social economy, enhance the economic efficiency, assure the implementation of the state's policy and promote socialist. Article 1 of the Chinese Contract Law 1999 states that the purpose of the law is to protect the lawful rights and interests of contracting parties, maintain social economic order and promote social modernization.

¹⁶² In 1993 the Chinese Legislature recommend to enact a new contract law and judges, scholars and expert proposed a report named "Draft Proposal of Contract Law". In 1995, legislative council set a conference to discuss the Draft and followed some scholars' and experts' advice to modify it to "Draft Proposal of Contract, Law II".

¹⁶³ Liang Huixing, The Debate Points in Drafting the Chinese Contract Law, (1996) China Legal Studies, p2

cases.¹⁶⁴ The above rules gave the legal basis for the court to establish exceptions to the privity doctrine.

3. To find out contracting parties' actual intentions and expectation at the time of contracts is Chinese courts' task in interpreting contracts. Where the contracting parties do not expressly or clearly fix in writing all their contractual rights, contractual liabilities or third parties' benefits in the contract, their intentions in relation to the matters not dealt with must be ascertained from the existing contract terms, and the specific contexts and surrounding circumstances. On the other hand, the courts are entitled to extend or limit the application of provisions so that they are used in accordance with the principle of honesty and trustworthiness and the principle of justice in different cases. Article 125 of the Chinese Contract Law 1999 provides that where a contract term is arguable, it should be interpreted according to the language utilized in the term, other relevant contract terms, the purpose of the contract, business custom and the principle of honesty and trustworthiness¹⁶⁵ in order to discover parties' true intentions in this term. In the process of interpretation of the meaning of a commercial contract, the Chinese courts favour a commercial construction in order to effectuate the parties' actual intention. Such an approach is characterised as meaning that the contract language is interpreted in the way that a reasonable person would construe it. Under the Contract Law, interpretation of a contract aims to ascertain the parties' common intentions, but is not limited to confirm the ordinary grammatical meaning of the words used in the contract.¹⁶⁶ It is generally accepted that interpretation of contracts should be in accordance with the parties' intentions, expectations

¹⁶⁴ Jiang Pin, Cheng Hehong & Shen Weixing: "Study on the Principles of Freedom & Honesty and Trustworthiness in the Chinese New Contract", Published on Legal Forum (periodical) (1999 Jan issue)

¹⁶⁵ The principle of honesty and trustworthiness means objective good faith which is regarded as a norm for the conduct of contracting parties, see above para 1.2.4.2

¹⁶⁶ Liang Huixin, 'On Civil Law and Commercial Law', Vol.6, Law Press, 85

and purpose in entering into the contract.¹⁶⁷ Where the contract language is ambiguous or the terms contradict with each others, the courts should adopt an interpretation which is in conformity to the commercial purpose of the transaction.¹⁶⁸ These approaches are favoured for their flexibility and fairer outcome rather than the literal one which was traditionally used in the Common Law systems.¹⁶⁹ As one scholar said:¹⁷⁰

The Chinese court when interpreting any of these provisions (provisions of the Chinese Civil Law and contract laws) should use a purposive, teleological approach rather than literalist common law methodology. Consequently, a positive obligation to conduct contractual negotiations candidly appears to be the favored *modus vivendi* for the future economic relationships in China.

2.2.1.1 Principle – Freedom of Contract

A first argument in favour of the third party beneficiary is that refusing the third party's action prevents realization of the contracting parties' intentions. Contracting parties are entitled to make an agreement for the benefit of third parties freely, and the agreement ought to be enforced by the law.

(a) *Background*

¹⁶⁷ Wu Tinggang, "Construction of Purpose of Contract", (2006) Shandong Social Science, issue no.9, 37; Song Yaohong, "On Construction of Contract", (2002) Modern Law Science, issue no.2 15; Chen Xinjie, "The Principles of Interpretation of Contract", http://www.hicourt.gov.cn/theory/artilce_list.asp?id=4220&l_class=2, 18 Feb 2007

¹⁶⁸ Shen Minrong, "Construction of Contract and Construed Contract", (2000) Nanjing Social Science, issue no.1, 43; Liu Xinghau, "On Principles of Construction of Contract", (2001) Theoretical Exploration, issue no.2, 76; Liu Shengguo, "Case Study othe Method of Contract Construction", (2005) Journal of Beijing City University, issue no.2, 59

¹⁶⁹ Ewan McKendrick, Contract Law, 6th Edition, p197

¹⁷⁰ Mark Williams, "An Introduction to General principles and formation of Contracts in the New Chinese Contract Law", (2001) 17 JCL, p.21

The freedom of contract and autonomy of parties' will are highly emphasized in the 'General Principles' part of the Chinese Contract Law 1999. Protection of parties' freedom and respect for their intentions are regarded as the most important aims of the Chinese contract laws. Since the new market-economy policy was established in 1979, a lot of scholars produced their opinions to stress the new legal concepts about freedom of the contract. Mr. Qiu Ben and Cui Jianyuan urged that the nature of private laws was to protect and favor people's legal rights appropriately and justly. The autonomy of parties' will is the basic principles which assures the functions of private laws, and it is also the impetus for the development of social economy by enhancing economic efficiency and promoting the people's creativity and enthusiasm in economic activities.¹⁷¹ Professor Zhang Wenxian expressed his idea about a 'private rights-centered legal system'. He stressed that in order to attain the purpose of social development and economic development, a private right-centered legal system is required, and the essence of it is individual freedom and autonomy of the will.¹⁷² Professor Jiang Pin stated that since the legal concept of the Chinese Civil Law was classified as private law, principles of equality, freedom and autonomy of the parties' will became the fundamental rules. He expressed the similar idea:¹⁷³

The central purpose of the Civil Law is to protect people's legal rights and obtain their interests in economic activities. Only the Civil Law adopts the principles of freedom and autonomy of the parties' will can it attain the purpose successfully.

The purpose of stressing the principle of freedom is to encourage contracting parties to actively join in the economic activities and smooth the transactions between them. In other words, the Contract Law ought to function basically as an instrument for the

¹⁷¹ Qiu Ben & Cui Jianyuan, "On Modernization of Legal System – Private Law and the Development of the Society" www.civillaw.com.cn/lawfore/CONTENT.ASP?programid=1&id=104 13 Feb 2003

¹⁷² Zhang Wenxian, "Development of the Law: From Obligation-Centered Legal System to Right-Centered Legal System", www.legaltheory.com.cn/info.asp?id=854 13 Feb 2003

¹⁷³ Jiang Pin, "Chinese Legal Theory", (periodical) No. 6 1998

contracting parties to effectuate their intentions. Wang Liming remarked:¹⁷⁴

The function of the new Contract Law is not to make any contract term for the contracting parties, but to protect and enforce the contract terms which the contracting parties agree to make themselves. The specific regulations in the Contract Law are applied only where the contracting parties make no expression about their affairs in the contract or it is impossible to infer the parties' original intention, then the contractual rules will take effect instead. Where the contracting parties have fixed their affairs explicitly in the contract, it is definitely unnecessary to apply the related contractual regulations. This is a correct way to comprehend the nature of the contract law.

Professor Guo Mingrui also said:¹⁷⁵

According to the notion of freedom, all the contract terms in respect of the contractual rights and obligations are decided by the contracting parties themselves. Their right of freedom will never be disturbed by any person or organization. A valid contract has a binding effect immediately, and the function of the Contract Law is just to assure the performance of it and provide remedial measures when the obligor breaks his promise.

(b) *Application in judicial practice*

From the 1980s, the principle of freedom of contract became the ground for the courts to solve cases in which the third party beneficiaries' rights were involved.

In *Hunan Cooperation v. Zhang Liang Grocery* case, decided in 1998¹⁷⁶, Shiye Fishery entered into a contract with Zhang Liang Grocery in October 1997. According to the contract terms Shiye Fishery was to provide a ton of grilled fish to Zhang Liang

¹⁷⁴ Wang Liming: "On Some Issues in the Chinese Contract Law", www.civillaw.com.cn/lawfore/CONTENT.ASP?programid=1&id=442 12 Feb 2003

¹⁷⁵ Guo Mingrui: "On Freedom of the Contract – An Insurance Case Study", www.civillaw.com.cn/lawfore/CONTENT.ASP?programid=1&id=117 20 Feb 2003

¹⁷⁶ Wang Liming: *Case studies in Chinese Civil Law*, (1998) Law Press, p.426.

Grocery before the end of November. Zhang Liang Grocery promised to pay Hunan Cooperation 25,000 Yuan within a month after it received the goods. This was because that Shieye Fishery owed Hunan Cooperation 30,000 Yuan in another contract. Later Zhang Liang Grocery paid just 5,000 yuan to Hunan Cooperation but refused to pay the rest. Then Hunan Cooperation sued Grocery at the end of 1997. The minority of judges insisted that Hunan Cooperation, as a stranger to the contract between Zhangliang Grocery and Shiye Fishery, was not able to sue the defendant in its own name. Their opinions were based on the privity doctrine:¹⁷⁷

Although Hunan Cooperation in this case has a special position, that is, it is the subject of the debtor's performance and has the right to receive the benefit from the contract, it is merely a stranger. The fact that Hunan Cooperation is not a contracting party means it is not the subject of the contractual rights and obligations. Only the contracting parties who are the subjects of contractual rights have the right to enforce the contract. The only way for Hunan Cooperation to claim its money back is to bring an action against Shiye Fishery upon the contract between themselves.

On the other hand, the majority of the judges held that Hunan Cooperation, as a third party beneficiary on whom the contracting parties in their contract had agreed to confer a benefit, had a relatively independent place in the contract and was entitled to enforce the contract in his own name.¹⁷⁸ Mr Fang Sahokun¹⁷⁹ summarised the majority's opinions:¹⁸⁰

This case concerns the typical problem of the third party beneficiary in a contract. Our laws respect contracting parties' will and their expectation in entering into contracts, therefore a valid contract has its legal effectiveness. In a normal case, a contract takes legal effect only between the contracting parties according to the privity doctrine. However, as long as the

¹⁷⁷ *ibid* p427

¹⁷⁸ *ibid* p427

¹⁷⁹ The commentator of this case.

¹⁸⁰ *Ibid* p427

agreement does not violate laws, public policy or other people's legitimate rights, our law should recognize its validity. That is, under some particular circumstances the legal effectiveness of a contract could expand to other people who are not the parties to the contract. A contract concerning the benefit for the third party is just involved in these particular circumstances.

In some judges' point of view,¹⁸¹ the condition to empower third parties to enforce the contract is that there must be some reasons explaining why the contracting parties are willing to confer benefit on a third party, for example, A and C have some special relations, say blood relatives; or A owes a debt, expresses gratitude or a favor to C and thereby intends to realise his wishes through B's performance of contractual obligations. In this case, Hunan Cooperation was a third party beneficiary who was able to enjoy the right to receive the agreed amount of money from Zhang Liang Grocery and also had the right to enforce the latter's promise. Zhang Liang Grocery should complete its performance not only because it agreed to do so but also because he got a ton of grilled fish from Shiye Fishery. The judges also emphasised that an agreement took effect independently at law - once the contracting parties entered into a contract, the fact whether or not the reason explaining why the obligee should give a benefit to the third party existed or was valid at law would not influence the creation and effectiveness of the contract in favour of a third party beneficiary.¹⁸² Therefore, the obligor could refuse to carry out his contractual obligations by reasons such as the obligee's debt to the third party does not exist any longer, or invalid at law. The court summarised:¹⁸³

After accepting the contract terms, the third party beneficiary is entitled to enjoy the right arising from the contract. He is entitled to ask for performance of the obligor directly and also has right to claim for the remedies in his own name if the obligor breaks his promise.

¹⁸¹ *ibid* p429

¹⁸² *ibid* p430

¹⁸³ *ibid* p431

On the other hand, the third party beneficiary is entitled to refuse or cancel his benefits created in the contract. However, the third party is not a contracting party, so he has no right to modify, rescind or cancel the original contract.

In this case, the Chinese court first proposed an integrated theory of third party beneficiary and confirmed that a third party beneficiary was entitled to get the benefit from a contract if the contract provided such a term. They believed that the law should protect his right to receive it. The court discussed at length about various reasons explaining why the obligee intended to confer a benefit on a third party and then denied any possibility that the obligor could make use of validity or non-existence of those various reasons. Therefore, according to the judges' opinion, a promise concerning the third party's benefit should be carried out and enforced, but it has nothing to do with the reasons why the obligee intends to do that.

Obviously in this case, the court based their opinions on the freedom of contract through emphasising to enforce an effectiveness of the contract and to realise the obligees' expectations in contracts.

Ganshen Pharmaceutical Factory v. Hong Kong Jinlong Ltd,¹⁸⁴ concerned the third party's right of action. Fuye Financial Lease Company (FLC) negotiated with Ganshen Pharmaceutical Factory (GPF) in 1989 about lease of a set of gauze-folding machines. Both parties made an agreement that FLC should lend a set of gauze-folding machines with first class quality to GPF for 36 months. In order to perform the contract, FLC then contracted with Hong Kong Jinlong Ltd. (HJL). FLC represented that it wanted to buy a set of gauze-folding machines in order to lend it to GPF. HJL promised to supply the machine to FLC before the end of March, and the contract required its quality and technical standard would be in conformity to GPF's later instructions. After two contracts were concluded FLC, HJL and GPF had a

¹⁸⁴ Selected Civil Cases of the Chinese Courts II, People's Court Press, p624

conference negotiating specific requirements of the machine's quality and some technology problems. Their meeting summary contained a clause which provided that Hong Kong Jinlong Ltd. should supply a set of gauze-folding machines with the quality to the standard which had been expressed in the conference; otherwise Hong Kong Jinlong Ltd would be responsible for repair at any time during the contract, and also Ganshen Pharmaceutical Factory was entitled to claim compensation from both HJL and Fuye Financial Lease Company if Ganshen suffered a loss resulting from defective or inoperative equipment. After operation and testing for a period of time, the machine was finally confirmed as defective. GPF claimed for remedies against both HJL and FLC before the Chinese International Economic Arbitration Committee. The arbitration supported GPF's claim with the following explanations:¹⁸⁵

First, the clause in the three parties' meeting summary regarding the machine's quality and technical capability was a part of the contract between HJL and FLC. Secondly, from the contract terms between HJL and FLC and the subsequent meeting summary, both HJL and FLC agreed that GPF would have a right to claim for remedies directly from HJL. This crucial factor decided GPF's action against HJL should be supported. Thirdly, HJL and FLC held joint liabilities for GPF's loss. Under the situation that HJL was incapable of compensating GPF's loss, FLC should take the rest of the compensation.

In another case *Spinning Mill v Kelun Cotton Mill & Jianshe Cotton Mill*,¹⁸⁶ under the contract between Kelun Cotton Mill and Spinning Mill, Kelun would provide twenty tons of band spinning material to Spinning Mill. At the same time, Kelun entered into another contract with Jianshe Cotton Mill to order twenty tons of spinning material. They agreed in the contract that Jianshe was in charge of delivering the goods to Spinning Mill so as to save delivery cost. Later as the material appreciated in value, JCM was not able to complete its contractual obligations.

¹⁸⁵ *ibid* p 629

¹⁸⁶ The case was decided in 1994. Wang Liming, *Case studies in Chinese Civil Law*, (1998) Law Press, p.148.

Spinning Mill had arranged the storage and was prepared to receive the goods. After asking for delivery several times without any reply, it requested KCM to carry out its contractual obligations. However, KCM refused to answer for it by reason that it was JCM who should be responsible for non-delivery. Then SM sued both KCM and JCM. Although there was an argument about whether SM was able to sue JCM, the court finally supported SM's action by reason that:¹⁸⁷

The freedom of the contract is a basic principle to abide by in the Chinese Civil Law and Chinese Economic Contract Law. The contracting parties are entitled to stipulation of any right and obligation for themselves in their contract. Autonomy of their will and their expectations are protected by the laws because all effective contracting terms ought to be enforced by the laws, unless these contract terms infringe laws or public policy. In this case, the agreement between JCM and KCM concerning JCM's liability to SM is a valid contract term which was made for efficiency and convenience. To entitle the Spinning Mill to claim the benefit just realizes the intentions of the contracting parties.

Maoyi Corporation v. Tucan Company & Susu Clothing Factory,¹⁸⁸ decided in 1991 is another case concerning the third party's right to claim for remedies in its own name. In September 1990, Tucan Company entered into a contract with Susu Clothing Factory and promised to provide 200,104 m regenerative cloth to Susu at the total price of 162,000 yuan. Before Tucan performed its obligation, the manager of Susu was changed. The new manager considered that regenerative cloth was not marketable and planned to cut the order. Tucan did not agree with this and requested each party to complete its obligations according to the contract. Later Susu got the information that Maoyi Corporation was willing to purchase regenerative cloth, so Susu made a contract with Maoyi in which contained a clause as follows: "Susu's right under the contract between Susu and Tucan to receive 200,104 m regenerate cloth are assigned to Maoyi.... Maoyi has the right to ask for delivery of the goods directly from Tucan."

¹⁸⁷ *ibid* p.151

¹⁸⁸ Wang Liming, *Case Studies in Chinese Civil Law*, (1998) Law Press, p.241.

Afterwards Susu sent a notice to Tucan asking him to deliver the goods directly to Maoyi. Tucan received the notice but did not reply. At the end of December Tucan delivered 200,104 m regenerate cloth to Maoyi. Later Maoyi found that the goods were seriously defective and claimed for damages against both Tucan & Susu.

One of the disputes in this case was whether Maoyi was entitled to sue Tucan. The court tried to answer the question based on assignment theory. Susu assigned his contractual right to receive the goods. Such an act took legal effect under the conditions of Tucan's agreement, according to article 91 of the Chinese Civil Code.¹⁸⁹ In this case Tucan did not answer Susu's notice about assignment, but its later act of delivery to Maoyi should be regarded as evidence that it had impliedly agreed. Maoyi was still a third party to the contract between Susu and Tucan, and assignment did not mean that Maoyi had replaced Susu as a party to the contract. This is because only under the circumstance that the contracting party assigns all his contractual rights and contractual obligations to a third party, will the latter become a new contracting party and obtain right of claim for remedies in his own name. In addition, in this case, Maoyi's obligation to pay for regenerative cloth was to Susu, instead to Tucan.

The difficulty in this case was the agreement between Maoyi and Susu which provided that Susu was not liable for delay of the delivery or defective goods. On the other hand no express contract terms stated that Susu assigned its rights of claim in the contract to Maoyi. Therefore, Maoyi's claim against Susu was likely to be a failure.

The court proposed two approaches to solve the problems. The majority held that third party, as an assignee, could have a right to claim damages from Tucan. The assignment agreement which released Susu's liability to Maoyi could be regarded as

¹⁸⁹ Article 91 of the Chinese Civil Code provides that a contracting party is able to assign part or whole contractual rights or contractual obligations to a third party under the condition of another contracting party's permission. And assignment should not to be aimed for profit.

the one containing an implied intention that Maoyi also assigned the right of claim in respect of postponed delivery or defective goods. The minority held that the agreement which released the Susu's liability to Maoyi should be treated as an invalid so that Maoyi could claim damages from Susu for defective goods. The reasons to support this opinion will be discussed in the next part.

2.2.1.2 The Principle of Justice & the Principle of Honesty and Trustworthiness

(a) Background

The principle of justice originates from the basic concept of Chinese Civil Law and contract laws – all parties joining in civil activities are equal. Their equal positions are recognised and protected by the law and their lawful interests are balanced by the law too.¹⁹⁰ The principle of justice directs the way in which the parties conduct negotiations and carry out their contractual obligations, and it also decides the validity of contracts and scope of remedies available to obligees.

The principle of honesty and trustworthiness is highly emphasised by the Chinese Civil Law and contract laws.¹⁹¹ The principle requires that all the parties shall be honest, faithful and well-meaning in joining the civil activities and contractual activities as well. They shall not misuse their rights or evade their obligations which are provided in laws or in contracts.¹⁹² Some scholars even regarded the principle as an 'imperial principle' in Chinese Contract Law, which means it is extremely important that contracting parties shall abide by the principle of honesty and trustworthiness when they enter into contracts, perform their contractual

¹⁹⁰ Article 2 and article 3 of the Chinese Civil Law, article 2 and article 3 of the Chinese Contract Law 1999

¹⁹¹ Article 4 of the Chinese Civil Law, article 4 of the Chinese Technology Contract Law and article 6 of the Chinese Contract Law 1999

¹⁹² Wang Liming & Cui Jianyuan, *New Study on Contract Law*, (2000) China Zhengfa University Press, p.108

obligations, modify or rescind their contracts, and keep their promise even after contracts are terminated.¹⁹³ In practice, the Chinese courts shall apply the principle of honesty and trustworthiness in an objective way and determine what the principle requires in the circumstances of the particular cases. The following cases show that the Chinese courts made decisions in favour of third parties according to the objective standard of the principle of honesty and trustworthiness.

(b) Application in judicial practice

*Wang Sushan & Xue Ming v Liu Xiaowei*¹⁹⁴ resulted in heated argument on whether a third party, Xue Ming, was able to sue on the contract. In 1991, Wang Sushan entered into a contract with Liu Xiaowei. Liu Xiaowei promised to rent a house to Wang Sushan. Since the house was very old and had been uninhabited for a long time, both parties emphasised that the house should be refurbished and to a standard of a satisfactory habitation. Almost three months after Wang Sushan and his wife, Xue Ming, moved into the house, the sitting room caught fire and most of the property in this room was damaged. The investigation report confirmed that no fuse was fitted in the room and the electrical wiring was in a very bad condition. Wang SuShan and Xue Ming brought an action for remedies regarding their respective loss.

Xue Ming was not a contracting party. Did she have a right to claim for damages on the contract between Wang Sushan and Liu Xiaowei? In this case, Xue Ming had the right to bring an action in tort according to the Chinese Civil Law, even if she was not allowed to sue on the contract. But under the circumstance that Xue Ming chose to bring an action on the contract, the problem whether she was able to sue must be resolved. The court finally decided to allow Xue Ming's right of action. The decision

¹⁹³ Chen Nianbin, "On the Principle of Honesty and Trustworthiness in the Contract Law", (2003) Science of Law, issue no.6, 59; Wang Luozhong, "The Principle of Honesty and Trustworthiness in the New Contract law", (2001) Public Administration and Law, issue no.1, 68

¹⁹⁴ Selected Civil Cases of the Chinese Courts II, People's Court Press 1998, p624-p647

considered the following factors:

1. Xue Ming had a special position in the contract between Wang Sushan and Liu Xiaowei. Xue Ming and Wang Sushan were family. Liu Xiaowei should be aware that Wang Sushan and his family would be living in the house. Both parties emphasised the contract clause defining the quality and standard of the house, not only for the benefit of Wang Sushan, but also for his family. Liu Xiaowei should be responsible for the whole family's loss of property caused by his breach of the contract, which Liu Xiaowei was able to anticipate when entering into the contract.
2. Although Xue Ming did not enter into the contract, she relied on the contract terms and whether her interests in habitation could be realized depended on Liu Xiaowei's accomplishment of his contractual obligations. The most important point is that Liu Xiao was able to foresee that quality problem of the house would endanger the whole family's life and property as well.
3. Chinese Civil Law allows that the plaintiff can choose freely to sue on contract or in tort if he is entitled to sue on both. Xue Ming chose to sue on the contract, so her action should be allowed. In the court's view, the long-established rule of privity of contract could be modified judicially in the light of the principle of justice and of honesty and trustworthiness.

Tong Jin v Hailong Gas-fired Boiler Ltd in 1999¹⁹⁵ concerned Hailong's liability for repair owned to Tong Jin. In 1995, under a contract between Hailong and Dai Keming, the former provided the installation work for a central gas heating boiler and was in charge of regular maintenance and repair free of charge for five years. Any subsequent owner of the flat would obtain the benefit of this guarantee. In 1998, Dai

¹⁹⁵ See Duan Chongzhi "Analysis And Evaluation Of Typical Civil Cases", Law Press, 2001, p275

Keming sold his flat to Tong Jin. They made an agreement in their contract as follows: Once Tong Jin registers as the new owner of the flat, Tong Jin will have all the rights which Dai Keming has in the current effective contracts regarding the flat and facilities. Later, when Tong Jin's request to repair was rejected by Hailong, Tong Jin was compelled to ask another company to carry out the work. Tong Jin was held entitled to recover the cost directly from Hailong. The court considered that the owner's rights established in the contract between Hailong and Dai Keming took legal effect in favour of Tong Jin. Therefore, Tong Jin was entitled to obtain benefits from Hailong's promise, and his right for recovery should be supported. In this case, Dai Keming's action against Hailong for Tong Jin's loss was not a practical way to resolve the problem. Dai Keming might refuse or could not to bring an action. It is unfair to put require Tong Jin to find Dai Keming and persuade him to sue.

In the *Spinning Mill v Kelun Cotton Mill & Jianshe Cotton Mill*,¹⁹⁶ the court finally supported Spinning Mill's action on the ground that Spinning Mill was a third party who actually took the benefit from Jianshe's performance of delivering the goods. In addition to the reason that the contracting parties' intention to confer a benefit on the third party should be recognised, another reason for the court to make such a decision is to avoid injustice. In this case Spinning Mill had reasonably relied on Jianshe's promise to deliver the goods - it had arranged the warehouse. Jianshe's non-performance caused loss to Spinning Mill. As Kelun had released its liability to Spinning Mill according to their agreement, and also refused to sue Jianshe on behalf of Spinning Mill, Spinning Mill should be allowed to recover the loss in his own name.¹⁹⁷

In the *Maoyi Corporation v. Tucan Company & Susu Clothing Factory*, Susu assigned Maoyi the right to accept delivery of the goods from Tucan, but Tucan failed

¹⁹⁶ The case is decided in 1994. See Wang Liming: "Case studies in Chinese Civil Law", Law Press 1998, p.148.

¹⁹⁷ *ibid* p.151

to deliver the goods. The problem arose from the agreement between Susu and Maoyi which did not expressly assign the right of claim under the contract between Susu and Tucan. Some judges held that if it was the fact that Susu did not have an intention to assign the right of claim to Maoyi, then the agreement which released Susu's liability to Maoyi should be treated as invalid. With the knowledge that Maoyi could sue neither Susu nor Tucan if Tucan failed to perform its contractual liabilities, Susu's action to assign the benefit but hold the right of claim violated the principle of justice and of honesty and trustworthiness.¹⁹⁸

Another case *Li Xuan & Wang Yafang v. Tieda Real Estate Development Corporation* case¹⁹⁹ was decided in 1996. Li Xuan entered into a contract for lease with Tieda Real Estate Development Corporation in 1996. Under the lease contract, Tieda rented a house to Li Xuan with a qualified-standard habitat including necessary living and working facilities. A few months later, Li Xuan and his wife Wang Yafang had terrible diarrhea and coma. Diagnosis and investigation showed the couple were developed toxemia because of having ingested infected water. Later testing determined that the water contained a large amount of bacterium and microbe that it was totally unsuitable for human consumption. Both Li Xuan and Wang Yafang paid treatment fee and brought an action for recovery of the cost, liquidated damages and spiritual damage. They thought that Tieda owed a liability to assure the quality of drinking water with a national standard. Tieda refused to cover Wang Yafang's loss by reason that Wang Yafang, as a stranger to the contract, was not entitled to sue on the contract.

The court did not support Tieda's averments, and held that Wang Yafang could recover her loss and claim damages. Before the final decision was made, there were

¹⁹⁸ Wang Liming: "Case studies in Chinese Civil Law", Law Press 1998, p.243

¹⁹⁹ See Ma Qiang: "The Contract for Protecting third parties", www.civillaw.com.cn/research/justice/default.asp 12 Feb 2003; Financial Law Forum, <http://fol.math.sdu.edu.cn/jrfy/content/content.php?id=76&tb=dxal>

two opposite opinions among the judges. The minority held that Wang Yafang was not a party to the contract and did not have the right to bring a contractual action in her own name. They considered the better way to resolve the problem was to dismiss Wang Yafang's lawsuit and advised her to sue in tort. The majority considered Wang Yafang should be allowed to sue on the contract because Tieda's promises in the contract were particularly related to her interests. As the tenant's wife, Wang Yafang was also living in the same House. The couples had obligations legally and morally caring for each other's living affairs. Not only Li Xuan but also Wang Yafang relied on the contract to realize their benefits in accommodation. The contract for rent of the house therefore extended its legal effectiveness to Wang Yafang. Tieda was responsible to complete the contractual obligations so as to realise both Li Xuan's and Wang Yafang's interests in the contract. In addition, Tieda could foresee Wang Yafang was likely to suffer physical injury or financial loss caused by his non-performance or unsatisfactory performance of the contract. According to the honesty and trustworthiness principle, Tieda's liability extended to Wang Yafang.

2.3 Various ways of application of fundamental principles to produce exceptions to the privity doctrine

2.3.1 Forseeable third party benefits and damages

Considering the third party has a special relationship with the obligee, if his interest unavoidably ties with performance of the contract, it is reasonable for the obligor to foresee that the his failure to carry out his promise will necessarily result in the third party's loss, and there is no other way for the third party to recover his loss under the contract law, then the third party is entitled to sue the obligee on the original contract.

2.3.1.1 Landlord's Liability to Third Parties

This technique was used in the *Li Xuan & Wang Yafang v Tieda Real Estate Development Corporation*. Li Xuan's requests for quality of accommodation and Tieda Corporation's promise of guarantee substantially influenced Wang Yafang's interests in personal safety and property. At least, on Li Xuan's part, his intention to make the agreement was not only for his own benefit. Tieda Corporation was able to anticipate the wife's prospective benefit and possible damages in its performance of the contract. The foreseeability of the third party's loss as a result of its failure to carry out its obligations does not necessarily mean the obligor owes a contractual duty to the third party. Decisions depend on the specific facts, the nature of the obligor's contractual liability and relationship between the obligee and the third party.

1. Li Xuan and Wang Yafang were family. They had an especially close relationship. They were responsible to take care of each other and Li Xuan had a sufficient interest in protecting his wife's and children's benefits. Therefore it was reasonably assumed that Li Xuan had an intention to make his family be able to enjoy the benefits in their accommodation when he entered into the contract with Tieda Corporation.
2. The proximity relationship between Li Xuan and Wang Yafang also made it reasonable for Tieda to know Wang Yafang's interest in the well-being of the property and to foresee her inevitable loss caused by defective quality of the premises at the time of the contract was made.
3. From the sense and purpose of the contract, and the principle of honesty and trustworthiness, Li Xuan's purposes and expectations in entering into the contract were frustrated by Tieda's defective performance. Tieda owes a duty of care to Wang Yafang and extension of its contractual liability in

this way is justified.

2.3.1.2 Contractual Chains

Generally speaking, the fact that A is able to foresee C's interests and possible loss caused by his breach of contract does not give the reason why C must be entitled to sue A. The parties who establish the structure of the contractual chains normally intend to keep their contractual rights and contractual liabilities between the two parties who enter into the same contract. In addition, since C is able to claim for remedies on the basis of his own contract, there is no necessity for the law to consider his right to sue A who has no contractual relationship with him.

However, the solution may be different under some conditions. For example, in a contractual chain linking a manufacturer, a wholesaler, a retailer and a consumer, the manufacturer and the wholesaler do not owe contractual duties to the consumer – no remedy in the contract laws is available to that party. But if the case contains special facts, for example, the manufacturer is appointed by the consumer, the quality of the products is specified under the consumer's specific instructions and the manufacturer well understands the consumer's benefits in the products, the decisions may be different. The courts may consider allowing the consumer to bring a contractual action based on the principle of honesty and trustworthiness, the purpose of contracts and expectations of contracting parties. Suppose in the *Ganshen Pharmaceutical Factory v. Hong Kong Jinlong Ltd*, if no agreement were made between the three parties to give Ganshen a direct right of action against Jin Long Ltd, the third party would also be allowed to sue Hong Kong Jin Long Ltd. This is because: (i) in this case, Jinlong was kept informed that its products would be eventually used by Ganshen; (ii) Ganshen gave Jin Long instructions on the quality of products directly in three parties' conference. Obviously, Jinlong was aware that its performance of the contract would directly affect Ganshen's interests. These facts make it clear that Jinlong could

anticipate that Ganshen would suffer a loss as a result of defective products.

2.3.1.3 Contracts of Services

In the *Xinyi Air-condition Fixing Company v Deli Shiye Ltd & Dongfang Accountants Co Ltd*,²⁰⁰ in 1995 Dongfang Accountant Co, negligently verified Deli company's investment capital and issued a document which proved that Deli Sheye had five million equity capital. In 1996, Deli asked a loan from Xinyi Air-condition Fixing Company with the above document to prove its ability to repay. Later Deli was not able to repay Xinyi Company. Xinyi Company then brought an action against both Deli and Dongfang Accountants Co claiming for repayment and interest. The court held that Deli Company and Dongfang Accountant Co were jointly responsible for returning money to Xinyi Company by the following reasons:

1. In legal theory, an accountant company, as an authorized institution, is liable for its services to clients and other third parties who will rely on its services. It must know that its clients and other parties will suffer loss as a result of defective services.
2. According to the Chinese Company Law²⁰¹ and Registered Accountants Law,²⁰² accountants are strictly responsible to guarantee the accuracy and precision of certification on financing. Dongfang Company broke the law and endangered other parties' interests.
3. In 1997, the Supreme Court's Response to Liabilities of Authorized Financing Investigation Institutes to Creditors in multi-cases gave a

²⁰⁰ Selected Civil Cases of the Chinese Courts Two, (2000) People's Court Press, p253

²⁰¹ Promulgated in 1993 and amended in 1999

²⁰² Promulgated in 1985 and amended in 1993

further explanation on accountants' liabilities:²⁰³

Where the debtors cannot pay off due debt, financial institutes and accountants should be responsible for loss of the third party creditors within the scope of the wrong proof or false proof they provide on their clients' financial status.

A recent case *Shi Jun v Beijing Dongcheng Notary Office*²⁰⁴ concerning the Notary Offices' liabilities to the disappointed legatee. In 1989, Shi Yun's grandmother Keng Songzhen wrote a will to pass her four rooms to Shi Jianqiang, Shi Kejian, Li Shulan and Shi Jian respectively. The will took legal effect under the notaries' No. 512 certification. Later Keng Songzhen changed her mind and wanted to pass one room's property right to Shi Yun, instead of to Shi Jianqiang. Dongcheng Notary, under the instructions of Keng Songzhen, changed the name in the No.512 certificate and stamped on it. In 2002, Keng Songzhen died. The four legatees registered for housing ownership according to the testament. Later the modified part of the testament was found invalid because the changed testament should have been issued under a new notary certificate. So Shi Jun could not get the property. After the failure of a claim for validity of the testament in court, Shi Jun brought an action against the Dongcheng Notary Office for the value of the estate property. According to the Chinese Testament Notarization Regulation,²⁰⁵ Shi Jun should get the compensation from Dongcheng Notary Office. At the moment, the Chinese Notarization Law Draft²⁰⁶ under discussion gives a general provision that the notaries who supply service are responsible for compensating loss of their clients and of other people whose interests are involved in their notary services.²⁰⁷

²⁰³ Issued in 1997

²⁰⁴ http://news.xinhuanet.com/legal/2005-03/21/content_2725540.htm, 27 Mar 2005

²⁰⁵ Under article 24 of the Chinese Testament Notarization regulation, notary offices are responsible for compensation if their registered notaries in fault make wrong notarial deed.

²⁰⁶ The Chinese Notaries Notarization Law Draft 2004

²⁰⁷ Article 51, the Chinese Notarization Law Draft

In China, professionals' services are classified by nature and judged by a standard criterion. They are liable to provide their services carefully and cautiously. In what circumstances and to what degree they bear liabilities for defective services are specified in the departmental laws, for example, notaries' liabilities in effectuating testament are specified in the Chinese Inheritance Law,²⁰⁸ their duties in issuing financing certificate are described in the Chinese Guarantee Law.²⁰⁹ In addition, notaries' duties in testifying adoption are provided in the Chinese Adoption Law.²¹⁰

2.3.2 Third Party beneficiary's reliance

In *Spinning Mill v Kelun Cotton Mill & Jianshe Cotton Mill*, Jianshe Cotton Mill promised in its contract with Kelun Cotton Mill that it would deliver the goods directly to Spinning Mill but finally it failed to do so. Spinning Mill suffered a loss through having rented a warehouse for storage. The court explained one of the reasons why Spinning Mill was allowed to sue Jianshe Cotton Mill was that Spinning Mill reasonably relied on the contract which it thought was binding on both contracting parties at law – Spinning Mill knew for sure that Jianshe Cotton Mill should have kept its promise or should take a legal responsibility for breach of contract. Reasonable reliance is a factor in deciding whether the third party is able to bring an action on the contract although a stranger to it.

Following this case, some Chinese scholars argued that the reason why a third party beneficiary is able to sue on the contract between the obligor and the obligee is because he has a "trust benefit" or "reliance interest" in the obligor's performance, based on the principle of fairness and the principle of honesty and trustworthiness.²¹¹

²⁰⁸ The Chinese Inheritance Law was promulgated in 1985.

²⁰⁹ The Chinese Guarantee law was promulgated in 1995

²¹⁰ The Chinese Adoption Law was promulgated in 1991

²¹¹ Ma Xinyan: "On Trust and Trust Benefit",

www.civillaw.com.cn/lawfore/CONTENT.ASP?programid=1&id=140 25 Feb 2003

Dr. Guo Mingrui expressed his opinion that a third party beneficiary whose benefit was defined in the contract between A and B, should be able to suppose that he had the same status as A and B.²¹² This is justified by the nature of the contract - the contract between A and B substantively originates from the mutual consent which is binding on both parties. As far as the third party beneficiary is concerned, once he accepts the contract terms concerning his benefits expressly or impliedly, there is agreement among the third party, A and B. If the theory that A's and B's contractual rights including enforceability should be protected by law is based on the contracting parties' reliance on each other's legally binding promises, it is reasonable to consider that C who comes into the contract with A and B and relies on their agreement should be entitled to sue on the contract in his own name. Dr. Guo Mingrui's opinion about "a third party becoming a subject of contractual rights" actually put the third party in the same status as the contracting parties. Professor Wang Jiafu objected to this opinion by reason that although the third party beneficiary indeed had a special position in the contract and his right to enjoy his benefit and claim for damages should be recognized, it was not reasonable to regard the third party beneficiary as having the same status with the contracting parties. This was because contracting parties had some exclusive rights, such as modifying, rescinding or terminating the contract, which the third party beneficiary never had.²¹³

Professor Wang Liming held that the obligor B owed a duty to carry out his promise to the third party beneficiary C because C had a reliance interest in his promise which exactly shows the operation of the principle of honesty and trustworthiness.²¹⁴ In other words, the duty of B to C imposed by the law is beyond

²¹² Guo Mingrui, "The Legal status and Characteristics of Third Party in the Contract for His Benefit", (1986) Legal Studies in China issue no.1

²¹³ Wang Jiafu: *Obligation in the Chinese Civil Law*, (1991) Publishing House of Law, p.4; Ding Chunyan, "The Protection of Third Party's Rights" in *Law Study's Success*, (2001) Beijing University Press, p192

²¹⁴ Wang Liming: "Some Issues in the Chinese Contract Law", www.civillaw.com.cn/CONTENT.ASP?programid=3&id=24 20 Feb 2003

B's contractual obligations, and is actually based on B's duty to join civil activities honestly and trustworthily as the principle requires. This extensive explanation of an obligor's duty was used in *Gaoxin Technology Industry Corporation v Huaxia Electronic Instruments Company*,²¹⁵ where Huaxia and Gaoxin had lengthy technological data negotiations. During negotiations, Gaoxin, the seller, performed substantial testing and program modification under Huaxia's instruction. However finally Huaxia did not want to make the contract. Then Gaoxin brought an action against Huaxia for investment loss. The court held that Huaxia owed a duty to compensate Gaoxin's loss by reason that Gaoxin had a "reliance interest" produced by its negotiation with Huaxia and Huaxia's instructions, and Gaoxin's recoverable damages were within the scope of value of investment which was made under Huaxia's instructions. Huaxia's duty to Gaoxin was not originated from a contract but produced by the requirements of the general principles. The same approach could also be used to extend an obligor's duty to a third party beneficiary who has reasonably relied on the former's promise.

A category of cases in which the third parties' reliance interests are protected by the laws are those concerning professionals' duties owed to third parties who have relied on their professional services.

The *Xinyi Air-condition Fixing Company v Deli Shiye Ltd & Dongfang Accountants Co Ltd*. case indicates that the third party who has reasonably relied on an accountant's valuation is able to sue the latter. In similar cases, whether the third party relies on the professional's faulty services is very important in deciding the professional's duty and its scope.

As mentioned above, an accountant's duty is produced directly from laws such as

²¹⁵ Wang Liming: "Some Issues in the Chinese Contract Law",
www.civillaw.com.cn/CONTENT.ASP?programid=3&id=24 20 Feb 2003

the Chinese Accounting Law,²¹⁶ the Chinese Certified Public Accountants Law,²¹⁷ and Regulations on Chief Accountants.²¹⁸ In China, professionals' services are classified by their nature and judged by a standard criterion. They are liable to provide their services carefully and cautiously. In what circumstances and to what degree they hold liabilities for defective services are respectively specified in the departmental laws and regulations. Liabilities of professionals like auditors, lawyers, evaluators and insurance brokers, according to the nature of their services, are fixed in the particular laws and regulations such as the Chinese Regulation for the Administration of the Valuation of State Assets,²¹⁹ the Chinese Audit Law,²²⁰ the Chinese Company Law,²²¹ the Chinese Insurance Law,²²² the Chinese Construction Law,²²³ the Chinese Real Estate Law and the Chinese Implementation Detailed Regulation.²²⁴

2.3.3 Performance objectives of the contracting parties' transactions

The parties' objectives in entering into a contract are highlighted in the Chinese Contract Law. Contract Law, according to article 1 of the Chinese Contract Law, functions basically as an instrument to protect the parties' lawful rights and to effectuate the contracting parties intentions and expectations. What will the Chinese courts consider when they decide whether a contractual remedy is available to a plaintiff and what contractual remedies are available to the plaintiff? Basically, their decisions are based on the purpose of completing the transactions. On the other hand, they aim to protect the parties' expectations and lawful rights. This is also shown in the courts' decisions in cases concerning contracts in favour of third parties. In theory,

²¹⁶ Promulgated in 1985 and amended in 1993

²¹⁷ Promulgated in 1993

²¹⁸ Promulgated in 1990

²¹⁹ Promulgated in 1991

²²⁰ Promulgated in 1988

²²¹ Promulgated in 1993 and amended in 1999

²²² Promulgated in 1995

²²³ Promulgated in 1997

²²⁴ Promulgated in 1994

where the third party obtaining a benefit from the contract is one of the contracting parties' purposes in entering the contract, the third party's right of action on the contract is considered. In practice, the courts may support the third party's suit by reason of the nature of the contract, the specific facts and the contracting parties' intentions when entering into the contract.

In the *Spinning Mill v Kelun Cotton Mill & Jianshe Cotton Mill* case, the court held that the third party beneficiary had the right to claim damages from its supplier's supplier especially when it could not recover the loss from an action against its supplier.²²⁵ The third party's right was based on the rationale that the obligor's intention to confer a benefit on a third party should be realised. A similar solution was applied also applied the *Li Xuan & Wang Yafang v Tieda Real Estate Development Corporation*, the court supported the third party, Wang Yafang's right to sue Tieda in contract by one of the reasons that Li Xuan's purpose and expectations in entering into the lease with Tieda was to make his family enjoy satisfactory quality of accommodation.

2.3.3.1 Interpretation of Contracts

In China, in order to infer contracting parties' genuine intentions accurately, interpretation of contracts is partly on the basis of the parties' subjective purpose when they enter into the contract. The Chinese Contract Law prescribes that, where there is a dispute between contracting parties about understanding of the contract terms, the terms should be interpreted according to the words, other related terms, the purposes of the transaction, business custom and the principle of honesty and trustworthiness. Where a contract is concluded in more than one language, the two versions containing the same words are interpreted to have the same meaning. If the two versions contain the different words, they are interpreted according to their

²²⁵ Wang Liming: "Case studies in Chinese Civil Law", Law Press 1998, pp.148, 151

purpose of the transaction.²²⁶

2.3.3.2 Substantial breach of contracts

In China, whether an obligor's failure to complete performance according to the contract constitutes substantial breach of the contract law depends on whether its outcome fails to realize the obligee's purpose in entering into the contract. Where an obligor's breach of the contract frustrates the obligee's original purpose in the transaction, the obligee is entitled to rescind the contract and claim for remedies.²²⁷

As the privity doctrine requires, in a contractual chain, contractual remedies are only available to the parties who have a contractual relationship with the defendants. However, there may be exceptions to this.

If a case contains some special facts which make the judges believe that application of the privity doctrine will lead to prejudice of the parties' intentions, expectations or purpose of their transactions, or lead to an unjust outcome, third parties may have a remedy. For example, many cases in contractual chains concern manufacturers' and wholesalers' liability for products. Normally they do not owe contractual liabilities towards the consumers directly. But the solution may be varied if the case contained some special facts. For example, the manufacturer is appointed by the consumer, the quality of the products is manufactured under the consumer's specific requirements and the consumer particularly relies on the manufacturer's capability and skills. Provided such a case happens in China, the court is likely to support the consumer's action in contract on the basis of the principle of honesty and trustworthiness, the purpose of the contract and the end aim of the contracting parties.

²²⁶ Article 125, Chinese Contract Law 1999

²²⁷ Article 94, Chinese Contract Law 1999

In a number of contracts, third party beneficiaries are entitled to claim for the performance of obligors' obligation and recovery of damages which is caused by obligors' breach of contract where the obligees' purpose and expectations are frustrated if the third parties' claim is disallowed by the law. Third parties' independent right of claim in class of contracts is recognised by the Chinese laws. For example, in contracts of personal insurance, beneficiaries of the insurance policies have rights to sue insurers.²²⁸ In contracts between shippers and carriers, consignees are entitled to claim remedies on the contract in their own name.²²⁹

2.4 Call for reform

2.4.1 Current problems in the creation of exceptions to the Privity doctrine

Basically, the exceptions to the privity doctrine are produced on the ground of the fundamental principles established in the Chinese Contract Law. These fundamental principles play important roles in the contract laws and are directly used where no provision can be properly applied in practice to resolve the third party beneficiaries' rights.

²²⁸ Article 21 of the Chinese Insurance Law (enacted in 1995) provides the definition of the "beneficiary" as "a party who has right of claim for the insurance indemnity is decided in the life insurance contract between the insurer and the insured". The beneficiary "is a third party to the insurance contract or the insured himself". Article 23 provides: "Any person or organization shall not disturb the beneficiary's right to claim for the insurance indemnity"; Article 26 Prescribes that in other insurance contracts except the life insurance contract, the insured or the third party beneficiary shall make a claim for the insurance money or the insurance indemnity within two years since the happening date of the insured event."

²²⁹ Article 58 of the Chinese Maritime Law prescribes: "Anyone including the shipper, owner of the goods and consignees are entitled to bring a lawsuit against the carrier for recovery of the loss of the goods, damages of the goods or delay of the carriage, whether the claimer's suit is based on tort or on the contract (including bill of lading), all regulations about liabilities and liabilities limitation of carrier in this law shall be applied".

It is correct that these fundamental principles have priority to be applied because they have strong legal effects as general provisions in the Chinese laws. The various principles cover broader meanings so that the Chinese courts are able to interpret them according to the specific facts of cases. On the one hand, such a way to apply the principles has its advantage in China because it could resolve the problems of deficiency of the contract laws, and avoid some unfair results arising from sticking to the provisions in a mechanical way. Some scholars highly emphasised the importance of flexible application of the principles. Mr. Deng Zhen stated that the discretion of judges to apply the basic principles filled a gap of the deficiency of the laws, and thus improved the social values of the laws as evenhandedness.²³⁰ However, on the other hand, application of the principles leads to uncertainty and instability in judicial practice, especially when the Chinese courts explain the principle of justice and the principle of honesty and trustworthiness in a pliable way.²³¹

1. The laws do not give an explicit definition of the various basic principles although there are general explanations in the academic sphere.²³² This gives judges chances to broaden the meanings of the principles. As Mark Williams has stated in his article:²³³

Fairness appears to be an amorphous concept and in line with civilian practice no definition is provided by the CL (Chinese Civil Law)... English law has no truck with such a concept and English judges appear to cling to a rigorous

²³⁰ Deng Zhen: "Study on Case Law's Function in China", www.civillaw.com.cn/lawfore/CONTENT.ASP?programid=1&id=217 21 Feb 2003

²³¹ Liang Huixing: "The Debate Points in Drafting the Chinese Contract Law", (1996)2 China Legal Studies; Wang Jiafu, *Obligations of Civil Law*, (1991) Publishing House of Law (1991), p. 8. www.civillaw.com.cn/lawfore/CONTENT.ASP?programid=1&id=254 18 Feb 2003; Guo Mingrui, "On Freedom of the Contract – An Insurance Case Study", www.civillaw.com.cn/lawfore/CONTENT.ASP?programid=1&id=117 20 Feb 2003

²³² Chinese scholars made almost the same definition of the basic principles in contract laws in their articles, books and reports.

²³³ Mark Williams, "An Introduction to General Principles and Formation of Contracts in the New Chinese Contract Law", (2001) 17 JCL, p.21

interpretation of contractual obligations as can be illustrate be the decision in *Union Eagle Ltd v Golden Achievement Ltd*.²³⁴ ... There is no definition of the principle of good faith in the CL, though a generous interpretation by a court is likely.

Different judges have different understandings and valuations based on their personal educational background. They may make totally different decisions on the same case where is no rigid explanation of the principles. For example, in the *Spinning Mill v Kelun Cotton Mill & Jianshe Cotton Mill*, the majority considered that the loss of the plaintiff for storage should be recovered, while the minority thought it was unjust for the defendant.²³⁵

2. Problems may arise in applying several principles at the same time in one case. Although it is generally accepted both in theory and in practice that the principle of freedom of contract is the most important and has priority to be applied over other principles. Various principles are still used in order to tell the parties' true intentions.
3. Sometimes a broad interpretation of the principle of fairness and the principle of honesty and trustworthiness may break the ambit of the law and go into the sphere of ethics. Difficulty in defining a general standard for social ethics makes for trouble in explaining the principles too.

2.4.2 Problems arising from article 64 of the Chinese Contract Law

According to article 64 of the Chinese Contract Law, the third party beneficiary only has the right to accept the benefits and to request performance during the before the contract ends, but he has no right to bring an action against the obligor in his own

²³⁴ [1997] 2 All ER 215

²³⁵ Wang Liming, *Case Studies in Chinese Civil Law*, (1998) Law Press, p.149

name if the latter breaches his obligations.²³⁶

1. Privity originates from the essence of private law and works for the purposes of protecting contracting parties' interests and smoothing their transactions. Normally, sticking to privity is a correct way to attain these purposes, but the contrary outcome may be achieved where the contracting parties intend to confer a benefit on a third party in their contract. The original purpose of the legislators in stipulating article 64 of the Chinese Contract Law must be protection of contracting parties' interests, especially the obligor's. But deprivation of the third party beneficiary's enforceability on contract does not attain the goal to protect the contracting parties' interests – it is just contrary to realization of the principle of freedom of contract.
2. It is contradictory for the law to recognise that third party beneficiaries have the right to obtain benefits which contracts confer on them, but on the other hand to deny his right to enforce the obligor's promises. In theory, successful performance of contractual liabilities relies on the parties' ability to enforce the contract and availability to effective remedies. Although third parties can choose to recover damages through obligees' actions, they may encounter difficulties in doing so where obligees cannot or do not want to bring an action to claim damages for third parties. In addition, according to the Chinese Civil Procedure law, all plaintiffs can recover the loss they suffer themselves only. Third parties suffer losses but only obligees can claim remedies: this is contradictory in theory.

The Chinese legislature is now preparing to enact a new Civil Code, and the project

²³⁶ The Legal Studies Office of People's Congress, Interpretation of the Chinese Contract Law, (1999) People's Court Press, p.102

attracts opinions from many judges, experts, scholars and practitioners. Many people have urged that the regulation in respect of third party beneficiaries should be modified in the coming Civil Code so as to make up the deficiency of article 64 of the Chinese Contract Law.²³⁷ Comparative study on the third party rule in different countries will be helpful to the Chinese law reform. Other countries' experiences in applying the third party rule in practice and solutions to the current problems may direct a way for the privity reform in China. Indeed it is interesting for us to see what the new regulation will be and how the Chinese courts continue to deal with the cases concerning the third party beneficiaries.

²³⁷ Ma Qiang, "The contract for Protecting Third Parties", www.civillaw.com.cn/research/justice/default.asp, 16 Feb 2003; Ding Chunyan, "The Protection of Third Party's Rights" in *Law Study's Success*, (2001) Beijing University Press p.192-193; Deng Haisang, *The Privity Doctrine and the Contract for the Third Party Rights*; Fu Jingkun, *Contract Law in Twentieth Century*, (1999) Law Press, p.153-157

CHAPTER 3

TEST OF ENFORCEABILITY

The Chinese contract law rules are or should be based on the functions and purposes of contract laws in regulating business activities, so this specifically requires that every rule should be the rule that is congruent with applicable social propositions. On the other hand, the contract law rules can be followed continuously and consistently, which reflects important legal values such as predictability and evenhandedness.

What kind of test of enforceability should be established in the Chinese Contract Law is an important issue, and it directly decides whether the reform in third party rights will be successful or not. According to the conclusion made in the chapter two, the reason why a third party should have a right to enforce a contract under the Chinese contract law is that empowering third party enforceability matches the nature of the contract, the target of contract laws and the basic principles. The Chinese legislative reform in third party right should be designed in line with this guidance. Therefore, as to the question in what circumstance a third party should be given the right of enforcement, the answer should be only when a third party acquiring a right of suit is in accordance with the nature of the contract, purpose of the contract law and basic principles, will he be permitted to enforce the contract.

The focus of this chapter is on the framework within which any conditions for third parties to acquire enforceable right beyond privity should be placed in the Chinese contract law reform. The discussion will be based on comparative legal

studies, the Chinese current statutes and Chinese judicial practice. The discussion will be divided into three parts. The first part is about the comparative analysis of various tests which have been suggested for the solution of these cases. The second part will be focused on whether these proposed approaches can fit into Chinese law's general conception of contract. The third part will examine how the proposed approaches would be applied to the three cases previously discussed.

3.1 Various Tests for third parties acquiring enforceable right beyond privity

3.1.1 Intention test

3.1.1.1 Express intention To Give Enforceable Right To Third Parties

A contract is defined as a series of promises which both parties agree to abide by or the consensus of ideas of the parties. In essence, the parties' promises or ideas are decided by contracting parties' intentions. The intentions of the contracting parties decide the type of their legal relations, what contractual rights and liabilities they have, the methods used to effectuate their lawful expectations. The importance of the parties' intentions is recognised in most countries' contract laws. Based on the belief, the fact that the parties have intentions to give an enforceable right to a third party is the simplest and most convincing reason for the law to allow the third parties to enforce the contract.

In English law the first limb of the test adopted in the Contracts (Rights of Third Parties) Act 1999 (Section 1(1)(a)) depends on whether the contracting parties have intentions to give third parties a right of action. The test is clear and self-evident, and

there is no reason to deny it whether in Common law or in Civil law.

It is easy to be applied in practice. The requirement is satisfied where the contract contains words such as “C shall have the right to enforce the contract” or “C shall have the right to enforce terms 25, 26 and 27 of the contract”, “C shall have the right to sue”,²³⁸ or “C is entitled to claim for damages if the promisor fails to perform the contract. The conjunctive requirement is provided in Section 1(3) of the English Act, which makes it clear that the third party must be expressly identified in the contract but does not necessarily have to be named in the contract. It is sufficient that the third party is expressly identified in the contract as a member of a class or as answering a particular description. In addition, the third party needs not to be in existence when the contract is entered into. Therefore, the third party who owns enforceability on the contract could be an unborn child, a future spouse, or a company that has not yet been incorporated under the provision.

In addition, third parties’ enforceability on exemption clauses will also fall within the scope of the test.²³⁹ That is, the third party is allowed to have the benefit of exemption clauses without having to rely on enforcement by the promisee if the parties expressly intent to exclude his liability. Although under some circumstances a third party may not enforce some contract terms because these terms are not enforceable according to the common law rules of *contra proferentem* interpretation and by statutory rules laid down in the Unfair Contract Terms Act 1977, this is just a result of the nature of the contract clauses but not a result of application of the privity doctrine. In the cases in which a “Himalaya clause” is involved, it is no longer necessary to regard a carrier as an agent or trustee of the persons who are or might be the promisee’s servants or agents in the contract in order that those people could acquire the protection of the exclusion clauses. Thus, stevedores and servants are able

²³⁸ Law Commission No 242, para 7.10, 78; see Andrew Burrows, “The Contracts (Rights of Third Parties) Act 1999 and Its Implication for Commercial Contracts”, [2000] LMCLQ 542

²³⁹ Law Commission No 242, Paras 7.10, p77; Michael Bridge, “The Contracts (Rights of Third Parties) Act 1999”, [2001] Vol5 ELR, p.88; see Andrew Burrows, *supra* note 238, 542

to take advantage of exclusion clauses under the “Himalaya clause” according to the above test. Similarly, problems of third parties’ rights produced from the exclusion clauses in the cases of construction contracts are resolved.²⁴⁰

Under this test, where the parties intend to create a right of enforcement for a third party but not intend to confer benefits on them, the third party still gets the right of actions in their own names. This opinion was accepted by some English consultees. On the contrary, the Scottish Law Commission took a different view, reasoning that a third party suffers no loss if he has merely bare title to sue but without benefit given from the parties.²⁴¹ Ultimately, however, even where there is no actual benefit conferred on a third party, his bare right of enforcement should be recognised because his right is given by both promisees and promisors. Our test resolves the problem of who has the power to sue, instead of the problem about the result of actions.

3.1.1.2 Intent-to-benefit Test

Intent-to-benefit test defines that a third party should be entitled to enforce a contract if the contracting parties intend to confer a benefit on him. Under the intent-to-benefit test, it is not difficult to ascertain the parties’ intention where the parties expressly agree to benefit the third party from the performance of the contract. The difficulty arises from the fact that the parties have implied intention to confer a benefit on a third party. In this case, the central question is in what way the parties’ intentions are appropriately interpreted, so as to ascertain the third parties’ actual intentions, and guidance should be formulated to help the judiciary to reach clear and predictable results.

²⁴⁰ For example, *Southern Water Authority v Carey & Others*, [1985] 2 AER 1077

²⁴¹ Scottish Law Commission, Memorandum No 38, Constitution and Proof of Voluntary Obligations: Stipulations in favour of third parties (1977) pp18-24

- (a) *A third party may enforce a contract which expressly in its terms purports to confer a benefit on him.*

(i) United States Law

Since 1960s, some American courts have largely used the test – whether the parties have intentions to benefit the third party.²⁴² In application of the intent-to-benefit test, most courts allowed the third party's right of action if the parties intended to benefit the third person or the contract was made for his benefit. No problem arises where contracting parties expressly purport to confer such a right on him in the contract: "*cases are easy to resolve where parties expressly provide a third party should have an enforceable right or not. Under the third party beneficiary principle, both types of provisions should be given effect – one type to allow enforcement by third parties and one type to deny such enforcement – because that result is required to effectuate the contracting parties' explicit objectives*".²⁴³ However, the argument arose at the same time about how to ascertain the parties' true intentions. In order to assist the search of the actual intention of the parties in practice, some courts decided that a third party could enforce the contract only where the parties had an express intention to confer a benefit on the third party.²⁴⁴ Some courts brought forward a stricter application of the intent-to-benefit test. For instance, in some cases, the parties' intention was manifested only when it was clear or definite.²⁴⁵ And some decisions required that the

²⁴² See *Buchman Plumbing Co. v Regents of the Univ. of Minn.*, 215 N.W. 2d 47, 483 (Minn. 1974); *Snyder plumbing & Heating Corp. v Purcell*, 195 N.Y.S. 2d 780, 783 (App. Div. 1960); *Vogel v Reed Supply Co.*, 177 S.E. 2d 273, 279 (N. C.1970); Harry G. Prince, *Perfecting the Third Party Beneficiary Standing Rule Under Section 302 of the Restatement (second) of Contracts*, 25 B.C.L. Rev. 919, 923 (1984); Note, *The Third Party Beneficiary Concept: A Proposal*, 57 Colum. L. Rev. 406, 408-09 (1957)

²⁴³ Melvin Aron Eisenberg, "Third party beneficiaries" [1992], *Columbia Law Review* 1358, 1377

²⁴⁴ *Khabbaz v Swartz*, 319 N.W. 2d 279, 285 (Iowa 1982); *Keel v Titan Constr. Corp.*, 639 P. 2d 1228, 1231 (Okla. 1981)

²⁴⁵ See *Security Mut. Casualty Co. v Pacura*, 402 So. 2d 1266, 1267 (Fla. Dist. Ct. App. 1981) (clear); *Donalson v Coca-Cola Co.*, 298 S.E. 2d 25, 27 (Ga. Ct. App. 1982) (clear); *Snyder Plumbing*, 195 N.Y.S. 2d at 783 (clear); *Kelly Healthy Care, inc v Prudential Ins. Co. of Am.*, 309 S.E. 2d 305, 307 (Va. 1983) (clear and definite) _

contract be intended for the third party's direct benefit.²⁴⁶ Some other cases imposed a requirement that the parties' intent must be found only in the language of the contract instead of based on the surrounding circumstances.²⁴⁷ Other courts put an additional requirement on the intent-to-benefit test – the performance must be rendered directly to the third party beneficiary.²⁴⁸

American Restatement Second described requirements of the intent-to-benefit test, which is provided in Section 302 (1)(b): “*Unless otherwise agreed between promisor and promisee, a beneficiary of a promise is an intended beneficiary if recognition of a right to performance in the beneficiary is appropriate to effectuate the intention of the parties and (b) either the circumstances indicate that the promisee intends to give the beneficiary the benefit of the promised performance.*” Under section 302, the third party is able to enforce the contract on condition that both the introductory clause and the subsection (b) are satisfied. The introductory clause focuses on the intention of the parties, which makes it clear that parties' intentions are controlling factor in deciding the third parties' enforceability. And the promisee's intention to benefit the third party can be inferred from the contract language. Without doubt under the Restatement Second provision, the third party is able to enforce the contract if the contract expressly contains words to confer a benefit on him. However, the introductory clause provides no further explanation of the word ‘appropriate’ and it is difficult for the courts to decide in what circumstances the third party's enforceable right will be ‘appropriate’ to make the party intentions effectuated and in what circumstances it will not be. The subsection (b) only requires that the promisee, instead of both contracting parties, must have an intention to give the third party the

²⁴⁶ *Willis v E.I. Dupont de Nemours Co.*, 76 F. Supp. 1010 (E.D. Okl. 1948); *Robins Dry Dock & Repair Co. v Flint*, 275 U.S. 303, 307 (1927); *Grand Lodge of the Scandinavian Fraternity v U.S. Fidelity & guarantee Co.*, 2 Wash 2^d 561, 569, 98 P. 2d 971, 975

²⁴⁷ *Securities Fund Servs., Inc. v American Nat'l Bank & Trust Co.*, 542 F. Supp. 323 329 (N.D. Ill. 1982)

²⁴⁸ See *Fidelity & Deposit Co. v Rainer*, 125 So. 55, 58-59 (Ala. 1929); *Carson Pirie Scott & Co. v Parrett*, 178 N.E. 498, 501-04 (Ill. 1931); Laurence P. Simpson, *Handbook of the Law of Contracts* § 117, at 246-8 (2d ed. 1965)

benefit. Technically speaking, it is odd that the Section 302 test requires that only the promisee must have an intention to confer a benefit on the third party but at the same time requires that both parties' intentions must be appropriately effectuated by the third party's enforceable right.

(ii) English Law

The calls for reform of the third party rule became remarkable from the 20th Century in England. The reason why a third party should be allowed to enforce a contract was also based on the intent-to-benefit test.²⁴⁹ In 1937, the Law Revision Committee's Sixth Interim Report stated that a third party should be able to enforce a contract which expressly in its terms purported to confer a benefit on him.²⁵⁰ Later in 1967 in the *Beswick v Beswick*,²⁵¹ Lord Reid cited with approval the Law Revision Committee's proposals that when a contract by its express terms purported to confer a benefit directly on a third party, it should be enforceable by the third party in its own name.

The test advocated by the Law Revision Committee's Sixth Interim Report was later adopted in the Western Australia Property Law Act 1969.²⁵² Section 11 provides: "... where a contract expressly in its terms purports to confer a benefit directly on a person who is not named as a party to the contract, the contract is... enforceable by

²⁴⁹ For example, in *Marching v Vernon* (1797) 1 Bos & P 101, n (c) Buller J said that, independently of the rules prevailing in mercantile transactions, if one person makes a promise to another for the benefit of a third, the third may maintain an action upon it.

²⁵⁰ Sixth Interim Report did not describe the test in detail so that it did not clarify whether the contracting parties must also have intention to confer a legal right of enforceability. Vagueness of the test leads to two kinds of interpretations: one is on the surface of it there is no such requirement but some of the consultees construed the test as laying down that the parties must expressly confer a legal right of enforceability. See Law Commission, at 72

²⁵¹ [1968] AC 8, 72

²⁵² Western Australia Property Law Act 1969, section 11 provides: "... where a contract expressly in its terms purports to confer a benefit directly on a person who is not names as a party to the contract, the contract is... enforceable by that person in his own name..."

that person in his own name...”

In practice, there are some cases where parties expressly confer benefits upon third parties but do not mention whether they intend to allow the third parties to enforce the contracts. These cases satisfy the requirement of the intent-to-benefit test. For example, the agreement between a contractor and a subcontractor is stipulated in the language “the subcontractor should finish the work to assure the employer’s requirements”. Or an agreement between the software-supplier and the consumers that the consumers must make sure to use the software without violating the manufacturer’s copyright. The contract between a travel agent and a hotel stipulates that the hotel guarantees five-star standard accommodation and breakfast to the travellers. However, these results may not be justified as an attempt to consider whether the parties actually have an intention to empower the third party to enforce the contract. On the other hand, if the test set in the Law Revision Committee is narrowly interpreted, it becomes an extremely narrow one which excludes cases in which the contracting parties have an implied intention to confer enforceable rights on third parties.²⁵³ The New Zealand Contracts and Commercial Law Reform Committee²⁵⁴ also criticized this test by evaluating the Western Australian legislation: “...it seems to exclude implied terms in favour of third parties...it does not clearly express the necessity for the promisor and promisee to have intended to confer a legal right on the third party”.

(iii) German Law

Para. 328 of the German Civil Code provides that ‘it can be agreed by the parties of a contract that a third person shall be directly entitled to demand the obliged performance from the obligor’. Although the German Civil Code does not expressly

²⁵³ Law Commission No 242 explained the reason to object to the test: “It is ambiguous and, on one interpretation, is too wide and, on another, too narrow.” para 7.52, 92

²⁵⁴ New Zealand Contracts and Commercial Law Reform Committee, *Privity of Contract* (1981), 49-50

state that the criterion to be applied, German courts and writers agree that the intention of the parties is the controlling factor in deciding whether the third party is allowed to enforce the contract.²⁵⁵ It is clear that a contract in favour of a third party's benefit is recognised if the parties' intention is expressly described in the contract provisions.

(iv) French Law

In French law, the intention-to-benefit test is also applied by the courts in third party beneficiary cases.²⁵⁶ A third party's right to enforce a contract depends on the express or implied intentions of contracting parties. The French courts decide whether the parties have an intention to confer a benefit on a third party relying on the proper interpretation of the contract – the language of the contract and the circumstances.²⁵⁷

(b) The parties have an implied intention to confer a benefit on a third party

In the absence of the express provisions, parties' intention to confer a benefit should be interpreted from the contract. A third party is entitled to enforce the contract if the parties' intention is proved. The central question here is in what way the parties' intention should be appropriately ascertained. Since theories of contract interpretation and judicial tradition are very different among the countries, different countries solve the problem in different ways.

(i) Interpretation based on "objective purpose of the contract"

True, courts and academic have tried – as is customary in German Law – to pin their

²⁵⁵ International Encyclopedia of Comparative Law – Rights of Third Parties 13-2113-21, p20

²⁵⁶ Chevallier, Obligations en general; Rev. trim.dr.civ. 1968, 143-148

²⁵⁷ International Encyclopedia of Comparative Law –Rights of Third Parties 13-21, p19, A typical formula is used in Cass, req. 20 Dec 1898 (supra n. 85) where the court referring to the problem of determining the parties' intention in a third party beneficiary situation said that "this is a matter of contractual interpretation which belongs to the exclusive sphere of the courts."

views on some article of the Code. Thus sometimes the expansion of the contract has been based on article 57 of the German Civil code – broad interpretation of the contract, implied intentions of the parties and end-aim of the transaction.²⁵⁸ According to the German Civil Code article 328 par. 2, the surrounding circumstances, especially the purpose of the contract, shall be used to as a decisional guide where the parties' intention is implied.²⁵⁹ Also in practice, if the intention of the parties is not clearly spelled out in the text of the agreement, the courts try to ascertain the purpose of the contract and then read into it all terms on which parties would have agreed had they fully understood that purpose and what is necessary and proper in order to accomplish it.²⁶⁰

The “objective purpose” interpretation originates from the tradition that German courts usually tend to adopt what is called the objective approach under which the parties' rights and obligations are determined by the objective meaning of their actions and of their verbal and documentary expressions.²⁶¹ However, it is arguable whether this type of approach is helpful in ascertaining the parties' actual intentions.

Compared to the German approach, the French courts give a wider explanation of “objective purpose” of the contract. In French the parties' intention to benefit the third party lies within the ‘sovereign power of assessment’ of the *juges du fond*.²⁶² In practice, under the pretext of finding the intention of the parties in relation to ambiguous terms or where the contract is silent, the courts attribute to the parties equitable intentions. In addition, the French lower courts possess a considerable discretion to find the existence of contracts for the benefit of third parties, ostensibly

²⁵⁸ B.S. Markesinis, An expanding tort law – the price of a rigid contract law, (1987) LQR, 354, at 360.

²⁵⁹ K.Zweigert & H. Kotz, An Introduction to Comparative Law, 3th Edition, p.459

²⁶⁰ http://www.ucl.ac.uk/laws/global_law/german-cases/cases_bundes.shtml?17jan1985, 15 November 2004; International Encyclopedia 13-21, p21; Cf. BGH 24 Feb 1954, LM BGB § 328 no. 6; RG 22 May 1910, RGZ 98, 208; RG 8 Feb. 1935, RGZ 147, 42; OLG Hamburg 2 Sept. 1947, MDR 1948, 52

²⁶¹ International Encyclopedia of Comparative Law –Rights of Third Parties 13-21, p21

²⁶² Larroumet, Contract, 861; Civ (1) 21.11.1978

on the basis of the implied intention of the parties, but often for thinly disguised reasons of policy which have nothing to do with intention. For instance, the decision of the French case Cour de Cassation in 1954 where a hospital asked the defendant, a blood transfusion centre, to provide a donor of blood for the plaintiff patient, and the centre provided a donor who had syphilis which was transmitted to the plaintiff. The court held that there was an implicit stipulation in favour of the plaintiff in the contract between the hospital and the centre.

(ii) Interpretation based on “subjective intention”

In application of the intent-to-benefit test in America, the argument arose at the same time about how to distinguish the parties’ different intentions. Since “intent” can refer either to the parties’ actual subjective intention or to objective intention,²⁶³ it is not easy to ascertain what the parties intend. For example, in a sub-contract made between a head-contractor and a subcontractor, the latter promises to do construction work in a suitable standard. Both the contracting parties know that the promise will benefit the employer ultimately, but the promisor’s subjective intention to make his promise is not to confer a benefit directly on the employer but to offer a quality construction to the head-contractor. Also, a subsequent owner of the building will benefit from the contract between a builder and an employer, which includes a contract term in respect of the builder’s promise that he would do a quality work. In these cases, third party beneficiaries will have enforceable rights although contracting parties may not have subjective intention to confer benefits on them but they only have knowledge that performance of the contract will benefit them. For another example, a solicitor who promises to prepare an effective will for a testator does not have a subjective intention to directly confer a benefit on prospective legatees, although the solicitor is aware that the legatees will get benefit from his performance of the promises.

²⁶³ Corbin on Contracts, Matthew Bender (2001), at 14-15, 18-20

American judicial practice has showed that courts using the intent-to-benefit test often failed to make clear what the “intent” exactly meant when applying this test.²⁶⁴ For example, in *Kaiser Aluminum Chemical Corp v IngersollRand Co.*²⁶⁵ and *Lake Placid Club Attached Lodge v Elizabethtown Builders, Inc.*,²⁶⁶ it was held that the employer was not an intended beneficiary of the contract between the head contractor and the subcontractor. However in *Syndoulos Lutheran Church v A.R.C. Industries, Inc.*,²⁶⁷ the employer was regarded as an intended beneficiary in the subcontract in order to avoid this problem. Most courts used the intent-to-benefit test to treat the issue as whether the contracting parties, or the promisee, had a subjective motive to confer a benefit on the third party as an end.²⁶⁸

(iii) Approach of classification

The 1932 Restatement (First) of Contracts allowed third parties who were either “a donee beneficiary” or “a creditor beneficiary” to enforce the contract. To be a Donee beneficiary must meet the requirement that the purpose of the promisee in obtaining the promise of all or part of the performance is to make a gift to the beneficiary or to confer upon him a right against the promisor to some performance neither due nor supposed or asserted to be due from the promisee to the beneficiary.²⁶⁹ A creditor beneficiary must be a person whose obtaining the performance of the promisor will satisfy an actual or supposed or asserted duty of the promisee to the beneficiary.²⁷⁰ The two categories are based on realisation of the promisee’s intention to give the third party a gift or a benefit he owes. However, the promisee’s intention is deducted from

²⁶⁴ For example, *State v Osborne*, 607 p.2d 369, 371 (Alaska 1980); *Little v Union Trust Co. of Maryland*, 412 A. 2d 1251, 1253 (Md. 1980)

²⁶⁵ 519 F. Supp. 60, 72-73 (S.D. Ga. 1981)

²⁶⁶ 521 N.Y.S. 2d 165, 166 (App. Div. 1987)

²⁶⁷ 662 P.2d 109, 114 (Alaska 1983)

²⁶⁸ Melvin Aron Eisenberg, “Third party beneficiaries” [1992] Columbia Law Review 1358, 1378-1379

²⁶⁹ Restatement First Section 133 (1) (a)

²⁷⁰ Restatement First Section 133 (1) (b)

his constructive purpose based on the interpretation of the contract, so the way of the Restatement First test is, in the above two situations third parties *are presumed to be* the promisee's intended beneficiaries regardless whether the promisees describe this in the contract. Furthermore, the First Restatement's test provided no guidance how a court was to determine whether the promisee actually had the purpose to confer a benefit on the third party. Therefore, the application of the test possibly leads to uncertainty and inconsistency. In addition, based on the nature of a contract, the Restatement First's test should not merely be based on the promisees' purposes whether the third party should be allowed to enforce a contract, but instead be decided by both parties' objectives and expectations at least.

To assist the search of the true intention of the parties, the German Civil Code has adopted the technique of laying down a number of presumptions which state that in certain situations the judge, if in doubt, is to presume the existence or non-existence of a third party's right to enforce the contract.²⁷¹ One such presumption against the existence of the third party's right is under the German Civil Code article 329 – where a party undertakes to pay the other party's creditor without assuming the debit, it is to be presumed in case of doubt that the creditor does not acquire a right to enforce the contract. On the other hand, article 330 contains a presumption that the third party should obtain the direct right of action. One typical case is the old Roman law rule of *donatio sub modo* – a gift accompanied by a condition to perform an act requested by the transferor of the property. Another case is where a person transfers all his property or goods to another person in exchange for the latter's promise to settle the former's debts to third parties.²⁷² In addition, article 330 contains the presumption that in those cases concerning an insurance or annuity policy, payment meant to be made to a third party is entitled to demand direct performance.

²⁷¹ International Encyclopedia of Comparative Law –Rights of Third Parties 13-21, p21

²⁷² Markesinis, The German Law of Obligation, Vol I The Law of Contracts and Restitution: A Comparative Introduction, (1997) p271

Similarly, in order to decide who should be entitled to enforce the contract among the people who in fact get benefit from the performance of a contract, the French law made use of an approach – to classify them into three categories:²⁷³ (i) those who incidentally benefit from the performance of contracts;²⁷⁴ (ii) those who are intended by the parties to benefit from the performance of contracts; (iii) those who are intended by the parties to have rights in regard to that performance. The third parties who are in the category (i) are not allowed to enforce the contract, while the third parties who fall in classes (ii) and (iii) are entitled to enforce the contract. Some of the French jurists even simply call both of them in terms of ‘contracts for third parties’.²⁷⁵

3.1.1.3 Dual Intention Test

(a) Scots law

Scots law allows contracts to create enforceable rights for third parties if that is the intention of the parties, the doctrine also named JQT meaning ‘right acquired by a third party’. The Scottish courts decided that if the contracting parties intend to let the third party get the benefit from the contract, the third party is allowed to enforce the contract.²⁷⁶ Since the controlling factor is the parties’ intention, it is very important for judges to ascertain the parties’ true intention which should be interpreted from language of the contract and manifested by the parties’ actions if their intention is not expressly described in the contract.²⁷⁷

In the *Scott Lithgow v GEC*²⁷⁸ in 1989, Scott Lithgow entered into a contract for the construction of a submarine for the Ministry of Defence. The electrical works

²⁷³ Simon Whittaker, *Privity of Contract and the Law of Tort: the French Experience*, (1995) OxJLS, 338-339

²⁷⁴ B. Nicolas, *The French Law of Contract* (OUP, 2nd ed, 1992) at 190

²⁷⁵ Carbonnier, *Obligations*, 213-214; Simon Whittaker, “*Privity of Contract and the Law of Tort: the French Experience*, (1995) OxJLS, 339

²⁷⁶ For example: *Allan’s Trustee v Lord Advocate* 1971 SC (HL) 45 at 54, CF, at 37, 41, 47

²⁷⁷ *Contracts and related obligations in Scotland* (3rd ed.) 1995

²⁷⁸ (1989) SC 412

were subcontracted to GEC but it was later found defective. The Ministry's delictual action against the GEC for defective work was rejected by Lord Clyde, whereas his contractual claim based on JQT succeeded. Lord Clyde explained:²⁷⁹

In general I can see no reason why a third party should not be entitled to sue for damages for negligence performance of a contract under the principle of *jus quaesitum tertio*, but whether he is entitled must be a matter of the intention of the contracting parties. That has to be ascertained from the terms of their contract...In the present case the third pursuers are not seeking implement of obligations under the subcontracts nor an alleged breach of obligations implied in those contracts. It may then appropriate to consider whether the parties to the subcontracts intended that the third pursuers should have the right to recover the damages for defective performance rather than simply a right to enforce the contract.

This was like the *Blumer & Co v Scott & Sons*²⁸⁰ case, in that this case involved defective performance by a sub-subcontractor, who was sued by the employer under the main contract. Lord Clyde held that if the sub-contract carried reference to the employer and was concluded to advance the interests of the employer then there *could* be a *jus quaesitum tertio*. Thus the employer, whose contract was not with the sub-sub-contractor but with the main contractor alone, *could* nevertheless have not just an interest in the performance by the sub-sub-contractor, but a contractual right in the form of a JQT.

One of the questions is whether the fact that a third party is clearly identified is a necessary factor to judge that the parties have intention to confer a benefit on him. Lord Wensleydale observed in the case of *Finnie v Glasgow & South-Western Railway Co.*²⁸¹ that the persons in whose favour the stipulation is made need not be named. While Lord Clyde said in *Scott Lithgow* it was enough that they should be sufficiently described and the stipulation be clearly meant to be in their favour. The

²⁷⁹ (1989) SC 412 (Lord Clyde)

²⁸⁰ (1874) 1 R 379

²⁸¹ (1857) 3 Macq. 75 at p.90

typical case denying existence of JQT is *Blumer & Co. v Scott & Sons* where Ellis agreed to purchase a ship from Blumer who later ordered engines from Scott & Sons but suffered a loss because Scott & Sons failed to deliver the engines on time. Ellis was held no right to sue on Scott's contract. Lord Ardmillan observed that Ellis was not named or described in the contract with Scott nor were the engines to be delivered to Ellis nor finished to their satisfaction. Thus it was not clearly apparent that the agreement was for his benefit.²⁸²

(b) *English Law*

It was set out provisionally in the English Consultation Paper that the third party should be able to enforce a contract only if the contracting parties intended that he should receive the benefit of performance and also intended to create a legal obligation enforceable by him.²⁸³ Both parties' intentions must be satisfied as the premise for the third party's right of action, so the test is a so called dual intention test.

Establishing the third party's right to enforce the contract means creating a direct liability in the promisor to the third party. Therefore, the test must be based on both parties' intentions. This requires that not only the third party can get the benefit from the contract as agreed by the parties but also, more importantly, the third party's right against the promisor is accepted by the parties, which is in accordance with the rule that in English contract law the intentions of the parties are important in two main areas – intention to create legal relations and establishing and construing the terms, express and implied, of the contract.²⁸⁴

The Law commission accepted the dual intention test and divided it into two limbs. This test of enforceability was later adopted in the Contracts (Rights of Third Parties) Act 1999. The first limb of the test has been discussed in the above part – a

²⁸² Sixth Interim Report (1937) Cmd 5449, paras 41-49

²⁸³ Consultation Paper No121, para 5.10

²⁸⁴ Law Commission No 242, para 7.7, 76

third party shall have the right to enforce a contractual provision where that right is given to him and he may be identified by name, class or description by an express term of the contract. The second limb is that a party shall also have the right to enforce a contractual provision where that provision purports to confer a benefit on the third party, who is expressly identified as a beneficiary of that provision, by name, class or description; but there shall be no right of enforceability under the second limb where on the proper construction of the contract it appears that the contracting parties did not intend the third party to have that right.

The second limb of the test attracted some criticism. Unlike the first limb of the test, the second limb may cause uncertainty because it depends on an implied intention of contracting parties to confer a legal right on a third party. However, the majority of the consultees believed that the second limb is necessary to be included as the test of enforcement of third parties. In theory, contractual rights as between two parties are not merely a matter of express rights. Rather they include implied rights through the concept of implied terms.²⁸⁵ The fundamental justification is totally the same for the contract law to recognize parties' express intention as well as their implied intention, so it is unreasonable not to effectuate contracting parties' intention where it is not expressly represented. The first limb of the test is under-inclusive, and a reform merely based on the first limb would be excessively narrow. The first limb can only be applied in a small number of contracts that do not commonly exist in everyday life. The fact should not be ignored where in some cases, contracting parties actually have an intention to allow the third party to enforce the contract, but they do not expressly describe it in their contract. Some cases with which the English courts once encountered difficulties caused by the privity doctrine will not be solved by application of the first limb of the test. For example, cases concerning payment to a third party, such as *Beswick v Beswick*²⁸⁶ and *Woodar Investment Development Ltd. v*

²⁸⁵ Andrew Burrows, "The Contracts (Rights of Third Parties) Act 1999 and Its Implication for Commercial Contracts", [2000] LMCLQ 543

²⁸⁶ [1968] AC, 58

Wimpey Construction UK Ltd;²⁸⁷ the booking of a holiday for family members or friends, such as *Jackson v Horizon Holidays Ltd*;²⁸⁸ or the taking out of liability insurance designed to protect third parties to the contract, as in *Trident General Insurance Co. Ltd v McNiece Bros.*²⁸⁹ In these cases, if only the first limb of the test were provided in the Act, the Act would not have improved the position of the third parties.²⁹⁰

Under the second limb of the test, two conditions must be satisfied. First, the second limb is applied only where a contract involves the term which purports to confer a benefit on a third party, and the third party is to receive a benefit directly from the promisor. Third party beneficiaries here do not cover those people who get consequential or incidental benefits stemming from the promisor's performance.²⁹¹ Secondly, in applying the second limb of the test, the third party beneficiary should be expressly identified in the contract. This is provided for in section (2) of the Act. The second limb is not applied where third parties are merely impliedly in mind.²⁹² These conditions assure that the contracting parties' intention to benefit the third party is clear and explicit. Compared to other countries' approaches, English law does not recognise the parties' assumed implied intention to confer a benefit on a third party, which is inferred from circumstances based on the parties' objective purpose or subjective motive. Once the parties' intention to benefit a third party is proved, the third party is likely to enforce the contract unless the contract indicates that the parties did not intend the third party to have such a right. Therefore the problem arose from the second limb of the test is how to discern the parties' intention where they have not expressly describe the third party's enforceability. Since the second limb reverses onus of proof in favour of a third party, contracting parties,

²⁸⁷ [1980] 1 WLR, 277

²⁸⁸ [1975] 1 WLR, 1468

²⁸⁹ (1988) 165 C.L.R. 107

²⁹⁰ Andrew Burrows, "The Contracts (Rights of Third Parties) Act 1999 and Its Implication for Commercial Contracts", [2000] LMCLQ 542, 543

²⁹¹ Ibid, 544

²⁹² Law Commission No 242, para 8.1, 95

normally the promisor in practice, may not prove that they have no such intention. It is argued that the presumption of enforceability by the third party is “a strong one”.²⁹³

On the other hand the parties can make clear their intention not to allow the third party to enforce the contract or to subject the third party’s enforceable right to some sort of condition. Where a contract term purports to confer a benefit on a third party but contracting parties do not want anything to do with the 1999 Act, a simple standard term can be included, for example: “A person who is not a party to this agreement shall have no right under the Contract (Rights of Third Parties) Act 1999 to enforce any of its terms” or “A person who is not a party to this agreement shall have no right to enforce any of its terms.”²⁹⁴

3.1.2 Performance objective test

3.1.2.1 American Law

Based on the answer to the central question why not every third-party beneficiary should be entitled to enforce contracts – in some cases, such enforcement would conflict with the interests of the contracting parties – it has been argued that a third party is able to enforce a contract if allowing him to enforce the contract is a necessary or important means of effectuating the contracting parties’ performance objectives, as manifested in the contract read in the light of surrounding circumstances.²⁹⁵ Compared with the intent-to-benefit test and the dual intention test, the performance objective test has following characters:

1. Under the performance objective test, the third party’s enforceability is

²⁹³ The view of professor Burrows (1996), the Law Commissioner who was responsible for preparation of the Report which led to 1999 Act; See Chitty on Contracts 28th ed., (2003), at 143

²⁹⁴ Andrew Burrows, “The Contracts (Rights of Third Parties) Act 1999 and Its Implication for Commercial Contracts”, [2000] LMCLQ 542,545

²⁹⁵ Melvin Aron Eisenberg, “Third party beneficiaries” [1992] Columbia Law Review 1358, 1385

judged by what the parties promised to the third party in the contract, and by the objectives of the transactions embodied in the contract. Performance objectives, read in the light of surrounding circumstances, must be those that the parties either know or should have known at the time the contract is made.

2. Unlike the intent-to-benefit test, which turns on whether the contracting parties had an other-regarding intention to benefit the third party, the performance objective test turns on whether allowing the third party to enforce the contract will further the self-regarding interests of the contracting parties.²⁹⁶ Therefore, under the performance objective test, the purpose of allowing suit by a third party is not to realize the third party's benefit, but to ensure that the contracting parties' performance objectives are effectuated.
3. Under the performance objective test, the law of third party beneficiaries is largely conceived as remedial, rather than substantive. Therefore, the question addressed by this test is not whether the contract creates a "right" in the third party, but whether empowering the third party to enforce the contract is a necessary or important means of effectuating the contracting parties' performance objectives.²⁹⁷

A donee beneficiary is entitled to enforce the contract where a performance objective of the parties is to give effect to a donative intention of the promisee by asking the promisor to carry out a performance that will benefit the third party. In *Seaver v Ransom*,²⁹⁸ Judge and Mrs. Beman made a contract in which Judge promised to leave a certain amount of money in his will to Marion, who was Mrs. Beman's

²⁹⁶ Robert P. Smith, Recent Case, 31 tex. L. Rev. 210, 211 (1952)

²⁹⁷ Melvin Aron Eisenberg, "Third party beneficiaries" [1992], Columbia Law Review 1358, 1386

²⁹⁸ 120 N.E. 639 (N.Y. 1918)

niece. But after Mrs. Beman's death, Judge broke his promise. It was argued that on these facts, a performance objective of the contracting parties was that a gift be made to Marion though the contract which obliged Judge to complete his performance, and allowing Marion to enforce the contract was an important means of effectuating that performance objective.²⁹⁹

It was also argued that a third party creditor beneficiary is entitled to enforce the contract under the performance test because, in theory, the performance objective of the contracting parties is that the promisee should be made economically free of his obligation to the third party through the promisor's commitment to discharge the debt himself. And the performance objective will not be effectuated if the promisor fails to carry out his promise to benefit the third party. Another case concerns disappointed legatees' right of action against negligent lawyers, which were recognised in most of American cases. A performance objective of the contracting parties, testator and lawyer, is to make whatever legal arrangement are required to ensure that on the testator's death a given benefit will be conferred on the prospective legatees.³⁰⁰ In order to effectuate this objective, it is important and indeed necessary to allow the prospective legatees to recover their loss against the lawyer.³⁰¹ However, it was held the performance objective test is not applicable to empower an employer to sue against a subcontractor because allowing such a right would ordinarily not be a necessary or important means of effectuating the performance objectives of the contracting parties, the head contractor and the subcontractor.³⁰²

The American scholar's thinking about the performance objective test points a way towards how to create a right for the third party to enforce a contract. As it was argued, the purpose to apply the performance objective test is to protect contracting parties' interest – to effectuate their objectives in contracts, instead of for third parties'

²⁹⁹ Melvin Aron Eisenberg, "Third party beneficiaries" [1992] *Columbia Law Review* 1358, 1390

³⁰⁰ *Ibid.* 1394

³⁰¹ *Guy v Liederbach*, 459 A. 2d 744, 751 (Pa. 1983); *Lucas v Hamm*, 364 P. 2d 685, 689 (Cal. 1961)

³⁰² Melvin Aron Eisenberg, "Third party beneficiaries" [1992] *Columbia Law Review* 1358, 1404

interest. However, this approach is not justified as reasonable and effective as the intention test, and possibly causes more difficulties in practice.

3.1.2.2 German law

In order to ascertain the parties' intention in absence of express stipulation, the German courts relied on purpose of the contract. But the objective of the contract is highly emphasised in practice so that in some types of cases, it will become a matter of objective interpretation which means the judges decided to empower the third parties' enforceability directly on the objectives of the contract. For example, in a German case concerning the passengers' right of action in a charter contract, an airline company chartered a number of seats to Company T in 1980. Company T passed on some of the seats to Company O, a travel agent, for an air package tour. Later the employees of the airline company refused to let the passenger Mrs H and her companion take the return flight because the company T had not paid total money due to the airline company.³⁰³ The court of appeal (Berufungsgericht) is of the opinion that the charter contract between company T. and the defendant constituted a true contract in favour of a third party as set out in para. 328 of the German Civil Code, by which Mrs. H. had obtained against the defendant a right to transport. The court's decision was based on the following reasoning:³⁰⁴

A charter contract obliges the chartered party to make available to the corridor seats on the flight organised by him. He knows that the persons to be transported are normally only named after the charter contract has been concluded, by the charterer or by a third person empowered to act for him, once package travel contracts have been signed. Thus under para. 328 (2) of the German Civil Code, it is the main purpose of a charter contract to transport air passengers who are identified to the chartered party only when the charterer or the third person insert their names on the air ticket. The contractual partners had intended that the

³⁰³ BGHZ 93, 271, VII. Civil Senate, (VII ZR 63/84), *Charterflug*-decision = NJW 1985,

³⁰⁴ http://www.ucl.ac.uk/laws/global_law/german-cases/cases_bundes.shtml?17jan1985 15 Nov 2004

contract had this particular aim. It is thus appropriate to assume that the air passengers who, at the time the charter contract was concluded would normally not be known, and in whose interests the charter contract was concluded, have direct contractual claim for transportation against the chartered party even where the charter contract does not contain an agency clause and their air tickets are not issued by the chartered party himself...The opinion held by most legal writers contractually holds that it is possible to construct the contract between the tour operator and the person providing the service as a contract in favour of a third party which provides the passenger with direct claims against the provider of the service.

This case indicated that the German courts also recognised that to effectuate the parties' performance objective is one of the reasons to allow the third party to enforce the contract. Here the crucial question is, who decides the performance objective of a particular contract, contracting parties, judges or statutes? It will be argued that the performance objective to a contract should be decided by contracting parties. But in practice, it is necessary for the court to infer the parties' performance objective according to the contract language and the circumstances, especially the type of a contract, which to a large degree affects the court's decision. Besides the cases concerning carriage of persons in connection with the services of travel agencies, the following examples also involve factual situations where contracts in favour of third parties based on the performance objective in Germany: parents contracting with doctors for the treatment of their child and contract of lease where family members of the lessee are regarded as beneficiaries of the contract.

3.1.2.3 French Law

French Law combines a highly consensualist conception of contract with a tradition of the legitimacy of legal regulation of the effects of particular types of contract. Therefore, the parties are free in principle to agree to what contracts they wish, and in most situations the law's response to this agreement is to classify it and regulate its

consequences.³⁰⁵ Where judges ascertain the performance objective of the contract largely based on the nature of the contract, the type of the contract becomes one of the most important factors to decide third party's enforceability. For example, the French court deduced the parties' performance objective from the nature of contracts involved a situation in which a hospital has contracted with an institution engaged in procuring and storing blood for transfusion purposes to deliver to a certain patient. The patient was held entitled to sue the institution as a third party beneficiary when the blood turned out to be faulty.³⁰⁶

3.1.3 Justice Test

An important question is whether the third parties should be allowed to enforce the contract based on some reasons which are irrelevant to the contracting parties' intention or performance objective but are related to perceptual justice. If recognition of third party enforceable rights can effectuate the parties' intention or obtain justice, there is no reason in principle why the laws prohibit third parties to enforce contracts, even in the absence of intention in the parties to create right beyond privity. It is also submitted that the intention test is a self-explained argument – the third parties cannot enforce the contract because his right of action is not in accordance with the parties' intention, which by no means excludes other techniques and concepts to be as the tests. In practice, in order to judge what kind of tests should be applied reasonably and justifiably, it is important to evaluate them in the context of different legal systems and specific necessity for judicial practice.

3.1.3.1 American Law

Under the justice test, a creditor beneficiary is allowed to enforce the contract if the

³⁰⁵ Simon Whittaker, "Privity of Contract and the Tort of Negligence: Future Directions", (1996) *OxJLS* 192, 194

³⁰⁶ Cass. Civ. 17 Dec. 1954; *International Encyclopedia of Comparative Law –Rights of Third Parties* 13-21, p20

promisee is not easily subject to suit, for example, the promisee is insolvent or incapacitated. In these situations, enforceability of the creditor helps prevent unjust enrichment of the promisor who has received consideration from the promisee. The justice test can also be applied in cases where an employer has paid for the contract price before the subcontractor's work was discovered to be defective and the head contractor has become insolvent. This is because if the head contractor has become insolvent, the employer's claim can only be brought against the head contractor's bankruptcy estate, but the employer normally has no incentive to sue the estate because the return in a suit against a bankruptcy estate typically constitutes only a fraction of debt.³⁰⁷

The American Restatement Second indicates that several factors should be considered in determining whether the third party should have a right to enforce the contract besides intent-to-benefit test. Comment d to article says:

Other cases may be quite similar in this respect... In such cases, if the beneficiary would be reasonable in relying on the promise as manifesting an intention to confer a right on him, he is an intended beneficiary. Where there is doubt whether such reliance would be reasonable, considerations of procedural convenience and other factors not strictly dependent on the manifested intention of the parties may affect the question whether under Subsection (1) recognition of a right in the beneficiary is appropriate. In some cases an overriding policy, which may be embodied in a statute, requires recognition of such a right without regard to the intention of the parties.

Therefore, under this provision, it seems that the third party beneficiaries are possibly entitled to enforce the contract beyond privity when these factors are taken into account - "reasonable reliance", "consideration of procedural convenience", and "overriding policy".

³⁰⁷ Melvin Aron Eisenberg, "Third party beneficiaries" [1992], *Columbia Law Review* 1358, 1405

3.1.3.2 French Law

In French Contract Law, both contracting parties' consensus and justice are highly emphasized. Therefore the criteria to determine third parties' enforceability should not only be based on one legal concept. It is argued that a better approach to develop true exceptions to privity of contract based on various justified principles is necessary, even in the absence of intention in the parties to create rights beyond privity. And there is no reason why the courts should not allow direct exception to privity where justice requires them.³⁰⁸

One example is that in French Law, the notion of "contractual group" is not only based on the intention of the parties but also based on a desire to bring the law into line with justice and commercial expectation.³⁰⁹ It is suggested that any liability beyond privity thereby created would be subject to a double limit on a claim made by a member of the network. Therefore in a construction contractual chain a subcontractor should be allowed to rely on an exemption clause in the subcontract against an employer even if the latter did not know of it.³¹⁰

However, unlike the American scholars' suggestions, it is not supported that a remote party is able to enforce the contract even if he cannot sue against his direct contractor who has become insolvent. It is submitted that in a case like *Simaan v Pilkington*³¹¹ in which a remote party is prevented by some practical or legal reason from suing up a chain of contracts – it is not enough to designate this as a 'breakdown', which requires remedying by the imposition of a direct liability.³¹² A

³⁰⁸ Simon Whittaker, *Privity of Contract and the Law of Tort: the French Experience*, OxJLS (1995), 193

³⁰⁹ J. N. Adams & Brownsword, 'Privity and the Concept of a Network Contracts' (1990) 10 LS 36

³¹⁰ Ibid. 34

³¹¹ [1988] QB 758

³¹² J. N. Adams & Brownsword, "Privity and the Concept of a Network Contracts" (1990) 10 LS 65; Simon Whittaker, "Privity of Contract and the Law of Tort: the French Experience", (1995) OxJLS, 199

direct right created in a contractual group requires a determination as to the worthiness for special protection of interests of a party beyond privity or some other specific reasons explaining why such a claim beyond the structure should be granted.³¹³

3.1.3.3 German Law

Under the German law, if parties' intentions are not explicitly expressed in the contract, an objective interpretation is required. In practice judges make decisions based on fairness and reasonableness according to the circumstances.³¹⁴ Although under German tort law, pure economic loss is recoverable only in special circumstances,³¹⁵ the German courts still used third party beneficiary doctrine to provide the plaintiff with a remedy where compensation for pecuniary harm seems fair and reasonable.³¹⁶

Under the German law, it is thought that a promisor's contractual obligations are twofold in some cases. For example, the landlord of a lease contract carries out performance of the obligation to deliver the premise but also takes responsibility to keep the premise in a safe condition and holds responsibility to the lessee's family members. In a contract of sale, besides responsibility of delivering the sold goods, the vendor is also subject to additional obligation to give adequate warnings where the product is dangerous or requires particular method of use. Otherwise the vendor is liable for physical injury to all users of goods. In carriage contracts, the shipper takes responsibility to give proper warnings if the goods to be transported are dangerous, and he is liable for the carrier's employee's physical injury if he fails to do so. Likewise, the promisor's secondary liability to third parties extends to cases

³¹³ Simon Whittaker, "Privity of Contract and the Law of Tort: the French Experience", (1995) *OxJLS*, 199

³¹⁴ Markesinis, *The German Law of Obligation, Vol I The Law of Contracts and Restitution: A Comparative Introduction*, (1997) p271

³¹⁵ Markesinis, *The German Law of Torts, A Comparative Introduction* (Oxford 1986) 32ss., 112ss.

³¹⁶ *International Encyclopedia* 13-21, p23

concerning injured workers in the construction contracts,³¹⁷ contracts of medical services.³¹⁸ The reasoning of third parties' rights in these cases is based on a broad interpretation of the contract, the implied intentions of the parties or even end-aim of the transaction. But under the influence of the late Professor Larenz, the new notion was increasingly separated from the traditional contracts in favour of third parties and based on the more amorphous idea of good faith contained in article 242 of the German Civil Code.³¹⁹ However, in practice, theoretical reasoning is not a problem for the courts. As it is said,³²⁰ what the courts are concerned with was doing justice to each case, leaving the theoretical justification of their result either undecided³²¹ or even treating it as irrelevant.³²²

The new notion was developed as the contract with protective effects towards third parties, under which certain third parties are entitled to claim for physical damages and even pure economic loss. One type of case concerns recovery of disappointed legatees' loss caused by a notary's negligence or inaction in performing his contractual obligations. It was argued that there were three points to decide the case based on the notion of contract with protective effects towards third parties: (i) under Para.823 of the German Civil Code, the pure economic loss caused by negligence was not recoverable in tort; (ii) the notary must have known that the proper performance of his contractual obligations was very important not only to the testator but also to the legatee, who would obtain benefits from an effective will; (iii) the legatee was the only person likely to suffer loss because of the defendant's

³¹⁷ BGHZ 33, 247

³¹⁸ BGHZ 2, 94; OLG Dusseldorf NJW 1975, 596, Case 41

³¹⁹ Markesinis, *The German Law of Obligation, Vol I The Law of Contracts and Restitution: A Comparative Introduction*, (1997) p278

³²⁰ Markesinis, *The German Law of Obligation, Vol I The Law of Contracts and Restitution: A Comparative Introduction*, (1997) p278

³²¹ BGHZ 56, 269 273

³²² BGH NJW 1977, 2073, 2074, Case 47

non-performance of his obligation.³²³

3.2 Recommendation of tests for the third party rule in Chinese law reform

3.2.1 The preferred test

What principles should determine whether a third party is able to enforce a contract? To answer this question, recall the reason why the issue concerning a third party's enforceable right was brought forward, and why not every third party who will get benefit from the promisor's performance has the right to enforce contracts: in some cases the basic principles, nature and purposes of Chinese contract laws require allowing such enforcement, but on the other hand in some other cases such enforcement would conflict with interests of contracting parties.

As demonstrated in the chapter two, there was the same basic concept in China on the principle of freedom of contract since the ECL started to adopt it in 1981 as one of the most important principles in the Chinese contract laws. In theory and in practice, the autonomy of the will of contracting parties must be respected, and they have freedom to create legal rights and obligations for themselves under the Chinese contract laws. Like the legal concept in Common law³²⁴ and Civil law,³²⁵ in China the contracting parties' consensus and intentions are also very important: contracting parties' intentions play the controlling role in creating legal rights both for themselves

³²³ Markesinis, *The German Law of Obligation, Vol I The Law of Contracts and Restitution: A Comparative Introduction*, (1997) p279

³²⁴ The intention of the contracting parties are important in two main areas: (i) intention to create legal relations; and (ii) establishing and construing the terms, express and implied, of the contract. See Law Commission No 242, Paras 7.17, p76

³²⁵ Consensualist conception of contract is highly emphasized in the French law and German law.

and the third parties - they decide the content of the contract and also the interpretation of the contract.³²⁶ Section 88 of the Chinese Civil Law (CCL 1986) provides that contracting parties ought to fulfill the contractual obligations according to their agreement, and only where there is no agreement between parties in respect of a particular matter, will the provision of laws be applied. Article 125 of the Chinese Contract Law 1999 provides that where a contract term is arguable, it should be interpreted according to the language utilized in the term, other relevant contract terms, the purpose of the contract, business custom and the principle of honesty and trustworthiness in order to discover parties' true intentions in this term. Under the Chinese law, the autonomy of the will of the contracting parties is highly emphasized. Therefore the contract laws should give effect to reasonable expectations of contracting parties.³²⁷ The contracting parties are free to create a right in the third party and the promisor is able to define his own "right-holder" so as to include the third party. The basic theoretical reason for support of third parties' enforceable rights is that our laws ought to effectuate contracting parties' intentions.

The above issues point the way to the criteria that should determine in what circumstances a third party has the right to enforce a contract. This criteria, which is also called the third-party-beneficiary test, is suggested as follows:

A third party shall have the right to enforce a contract if, but only if:

- (i) The contracting parties expressly confer an enforceable right on a third party in their contract; or

³²⁶ Chinese scholars think that the nature of interpretation of contract is to discover contracting parties' actual intentions. The Process of interpretation is a procedure using proper approaches to explore contracting parties true intentions. See Zhang Bin, "Some Issues in the interpretation of contract", <http://www.civillaw.com.cn/lawfore/CONTENT.ASP?programid=4&id=136> 2 June 2003; Cui Jianyuan & Yang Minggang, "How to Judge the Meaning of Contract Terms – Study on Contract Interpretation", (1996) Law Journal issue no.12.

³²⁷ *Darlington B.C. v. Wiltshier Northern Ltd.* [1995] WLR, p.76

- (ii) The contracting parties confer a benefit on a third party in their contract, who is expressly identified as a beneficiary of the contract term, by name, class or description; but the third party's enforceable right is subject to the construction, from contract language and surrounding circumstances, of the contract that the contracting parties did not intend the third party to have that right. The third party's enforceable right is also rebutted where he can acquire an at least equivalent remedy through his own claim rest on his own contract.

This is the dual intention test which is adopted in the English 1999 Contracts Act. Compared with the various tests used in other countries, I think the dual intention test is the most appropriate one to be adopted in the Chinese contract law reform. There are three main reasons for this:

1. The dual intention test emphasizes that in deciding whether a third party shall be given an enforceable right, not only contracting parties have an intention to confer a benefit on the third party but also they agreed to create an enforceable right in the third party. According to the nature of contract, the principle of freedom of contract and the purpose of the Chinese Contract Law, parties are entitled to create contractual rights and contractual obligations in the contract. Unless the contractual provisions conflict with article 52 of the Chinese Contract Law, these rights and obligations will take legal effect.³²⁸ The parties'

³²⁸ Article 52 of the Chinese Contract Law provides: "A contract term is invalid in the following circumstances 1, A party enters into a contract deceitfully and menacingly, or with an intention to damage the state's interest; 2, contracting parties collude together to enter into a contract with an intention to damage the state's, collective or a third party's interest; 3, parties try to cover an illegal

right to create a benefit and an enforceable right for a third party should also be recognised. On the other hand, contracting parties' agreement to confer a benefit on a third party does not necessarily mean that they agree to allow a third party to enforce the contract. The dual intention test avoids allowing a third party to enforce a contract where the contracting parties only intend to confer a benefit on him but do not intend to confer him an enforceable right. For example, A orders a piece of furniture from B and tells B that furniture is a gift for C. However, the contract provision which provides that if B fails to deliver furniture on time or furniture is defective, B has to pay damages to A. This provision indicates that A and B do not have an intention to allow C to enforce the contract. For another example, a sub-contract between A and B contains a provision: B has to finish printing and dyeing work for two tons of cloth which belongs to C within three months and the work must be done in a top standard. In a contract chain, a contractual term like this will normally not be regarded as the one which the contracting parties intend to allow the third party to enforce the contract.

2. Not only contracting parties' express intentions but also implied intentions should be effectuated. The dual intention test must also be applied to the cases where parties have an implied intention to allow a third party to enforce contracts. The problem is solved with reverse burden of proof in promisors – contracts containing terms for third parties' benefits are construed that contracting parties allow the third parties to have enforceable rights unless promisors are able to prove it is not true.

3. The French, German and American experiences have shown that application of intent-to-benefit test resulted in an unlimited expansion of promisors' liability to third parties. In order to solve this problem, the courts tried to find some solutions. For example, in America, since intent-to-benefit test did not provide an effective guidance to distinguish the third parties who should have a right to enforce contracts from those who should not, the courts used the direct-performance test as an additional test, or use adjunctive theory such as creditor third party beneficiary and donee third party beneficiary for a further explanation why third parties' enforceable right should be recognised. In Germany, the existence of a third party's enforceable right is to be presumed where the parties have purported to make provision for a third party.³²⁹ This presumption is too broad and sweeping. In order to solve the difficulty caused by the broad rule, a more cautious course was adopted and article 330 of the German Civil Code sets out a statutory presumption limited to only three specific cases.³³⁰ Application of the intent-to-benefit test together with additional courses makes confusion and uncertainty in practice. The dual intention test causes less uncertainty compared with other tests, which are based on presumption of parties' intentions. The advantages of the test are compatible with the Chinese legal system. This is because the Chinese legal system is a written law

³²⁹ The three cases, set out in the German Civil Law is: a) life insurance or annuity policy in which payments to a third party have been stipulated; b) where a person transfers all his assets or an agricultural estate to another party and the transferee, in order to buy off third persons, agrees to make certain payments to them; c) if a person makes a gift to another and the donee is charged with some performance to be made to a third person the latter, in case of doubt, is presumed to acquire a right to enforce the charge for his benefit. See International Encyclopedia 13-21, p22

³³⁰ International Encyclopedia 13-21, p22

system, that is, the courts' decisions only depend on the statutory provisions and facts of cases. Decisions of the previous cases can only be used for reference to some degree but cannot be as basis of decisions directly. Therefore, it is better for the Chinese Contract Law to adopt a definite and explicit test rather than a vague one, and also the provision in respect of the test of enforcement is feasible and practical.

3.2.2 The application of the preferred test

In order to further examine whether it is proper and reasonable to use the dual intention test in the Chinese Contract law, the following discussion will refer to four typical cases.

3.2.2.1 Liability for Defective Products

Before examining the application of the dual intention test, let us recall the problem concerning the sub-purchaser's right against the manufacturer under the present Chinese statutory framework.

First, under the Chinese laws, a manufacturer's or distributor's liability for defective products causing personal injuries or damage to property is normally considered a matter for tort. Article 122 of the Chinese Civil Law provides that the sub-purchaser or the consumer is entitled to sue the manufacturer in tort if the defective products cause personal injury or damage to property. Under article 43 of the Chinese Guarantee for Quality of Goods Law,³³¹ a buyer or a user who suffers a

³³¹ Guarantee for Quality of Goods Law (Amendment) was promulgated on 8 July 2000 and put into force on 1 Sep 2000. The old Chinese Guarantee for Quality of Goods Law was promulgated on 2 February 1993 and implemented on 1 September 1993.

personal injury or damage to property caused by defective goods, is entitled to claim for compensation either from the merchants or manufacturer. Therefore, there are two basis of manufacturer's liability in tort – in the tort of negligence and the Guarantee for Quality of Goods Law – both of which impose liability on those in a chain even irrespective of exemption clauses in the contracts under which they work.

Secondly, a question is whether a sub-purchaser is able to rely on the contract term to claim damages “pure economic loss” caused by defective goods.

Under the present Chinese laws, no direct liability is put on a manufacturer or other distributors as regards “pure economic loss” caused by a defective product to a sub-purchaser or an end-user. As article 40 of the Guarantee for Quality of Goods Law provides:

A merchant bears liabilities to repair, replace or return the products sold if the products are proved defective.³³² If the defect was caused by the manufacturer or other suppliers, the merchant has a right for recourse. Where the contracts between them have different agreements about these matters, these agreements will be applied first.

Article 35 of the Chinese Consumer Protection Law provides:

Where a consumer's lawful interests are damaged when he purchases or uses the product, he is entitled to claim for compensation from the merchant. If the damage is actually caused by the defect of goods as a result of the manufacturer's fault or other middlemen's fault, the merchant has right to ask for recourse after he compensates the consumer.

Therefore, in a normal case concerning defective goods, without suffering personal injury or property damage, a consumer or an end-purchaser can only bring an action

³³² Defects include: 1, the product has no necessary function which it should have, and there is also no advanced description about lack of function; 2, quality of product is not in consistence with that provided instructions and explanation; 3, the situation of the product is not in consistence with that showed as examples.

against a retailer or middle seller who has a contractual relation with him but cannot directly claim damages from a manufacturer or a distributor. Every party's enforceable right is kept in his own contract.

In addition, the agreement on warranties of quality between a manufacturer and retailer does not help to change the consumer or the sub-purchaser's position. In the absence of express contractual provision, there was and is no right in a buyer which can be transmitted with the products. The Chinese law does not recognise the transmission of a buyer's rights as to quality implied in contracts for the sale of goods.³³³

According to English Law before the 1999 Third Party Rights Act, a consumer was mostly unlikely to have a remedy in contract, and also after *Murphy v Brentwood DC*³³⁴ a consumer was not able to have a remedy in tort unless the defect caused physical injury or damaged other property.³³⁵ Even if the problem arises directly from the defect in manufacture, the consumer does not have a remedy in either contract or tort against the manufacturer.³³⁶ Now after the English law reform, a manufacturer and retailer could expressly confer legal rights on the purchaser to enforce the contract as regards the quality of the goods purchased. Only an express term to confer legal rights will make the purchaser be able to claim remedy in contract. Otherwise the purchaser would normally have no such right because even if he was expressly identified as a beneficiary of the manufacturer's contract with the retailer, the chain of

³³³ But in some cases, where the consumer or sub-purchaser brought actions against the retailer, the court added manufacturer, distributor or wholesaler as an co-defendant or a third party in action if there are warranties of quality of goods, and also judges thought defect of goods is caused by his fault. In decisions of the following cases, the consumer or sub-purchaser were able to recover damages directly from the manufacturer, distributor or the wholesaler. For example, in the *Yi Chang City Yong Long Machine Company v Yi Chang City Ge Zhouba Lida Company*, the plaintiff, the ultimate consumer was supported by the court to enforce the warranties of quality of goods and claim damages of repair fee directly from dealer. Please see "Selected Cases of People's Court" (Commercial Branch), (2002) Chinese Fazhi Press, p.78

³³⁴ [1991] AC 398

³³⁵ Hugh Beale, "Privity of Contract, Judicial and Legislative Reform", (1995) JCL, p.115

³³⁶ Treitel, Law of Contract, 10th Ed., 1999, p566-567

contracts giving the purchaser a remedy against the retailer for the manufacturer's breach means on a proper construction of the contract, and construed in the light of the surrounding circumstances, the manufacturer and retailer do not intend to confer an enforceable right on the third party.³³⁷

Under Scots law, the consumer may successfully sue the manufacturer as long as it can be proved that the contract between the manufacturer and the retailer purports to give him an enforceable right to claim for damages of the defective goods. In France, a sub-purchaser could bring a contractual claim in a chain of contracts of supply against original supplier or a subsequent seller in respect of latent defects in the material supplied.³³⁸ Extension of the liability of manufacturers or distributors not only gives compensation for personal injury and damage to property caused by the defective product in question, but also gives compensation for pure economic losses. The technical justification for this apparent breach of privity of contract is said to lie in the transmission under subsequent contracts of the initial buyer's right to sue the manufacturer.³³⁹ Similarly, the German Law also allows manufacturer's contractual liability to extend down a chain of contracts of supply to enable the ultimate user to sue the manufacturer or the original supplier under guarantees given in the initial contract supply.³⁴⁰

According to the current contract laws, the situation would be different in China even if the retailer and the manufacturer expressly agreed in their contract that the manufacturer bore liabilities directly to the consumers.³⁴¹ In such a case, the

³³⁷ Law Commission No.242, note 44, p93

³³⁸ Hector L. MacQueen, "Concrete Solutions to Liability: Changing Perspectives in Contract and Delict", (1998) *Arbitration: Journal of the Chartered Institute of Arbitrators* Vol. 64, 285, 290

³³⁹ Simon Whittaker, *Privity of Contract and the Tort of Negligence: future directions*, (1996) *OxJLS* 192, 200

³⁴⁰ Hector L. MacQueen, "Concrete Solutions to Liability: Changing Perspectives in Contract and Delict", (1998) *Arbitration: Journal of the Chartered Institute of Arbitrators* Vol. 64, 285, 291

³⁴¹ The Chinese Guarantee for Quality of Goods Law provides that the manufacturer and merchant hold a liability of guarantee for their goods provided, but there is no direct contractual liability in the

consumer's enforceable right could be based on third party's right, which actually depends on intentions of the contracting parties. But this conclusion in respect of third party's right is only based on the presumption that the Chinese law has reformed the privity doctrine and has recognized third party beneficiaries' rights. Under the recommended dual intention test, the manufacturer's contractual liability will not definitely extend to the sub-purchaser or the end-user where the latter has not been expressly identified in the contract, although the contracting parties normally have good knowledge that the contract terms will benefit the prospective purchasers.³⁴² This is because the absence of the sub-purchaser's identification and details in the contract give no indication that contracting parties have an intention to confer a benefit on the sub-purchaser or allow him to enforce the contract term.

With express identification of sub-purchasers, for example, the contracting parties use words "*the manufacturer must guarantee the quality of goods thereby also satisfies prospective consumer's requirements*", or directly confer a legal right on the consumers for example, using the words "*the purchasers and ultimate consumers are able to sue the manufacturer in their own name*", a sub-purchaser or end-user who finds defect of the goods will have an right to sue the manufacturer. In this situation, extension of the liability of manufacturers and distributors to sub-purchasers is characterised as contractual actions.³⁴³

3.2.2.2 Liability for Defective Construction

manufacturer created from this provision to the consumer, unless there is a contract to that effect between the parties.

³⁴² But under the intent-to-benefit test, it would be difficult to judge whether the third party was intended to enforce the contract from the warranties of quality terms and the fact that the manufacturer knowledge that performance would benefit the sub-purchaser or end-user.

³⁴³ In China, contractual liabilities are mainly created by the agreements between contracting parties but some of them are directly created by laws in China. Sometimes contractual liability is created because a contracting party's non-performance or mis-performance which is not in consistence with the contract or relevant legal regulations, and thus leads to adverse results. Han Shiyuan, "Debatable Issues and Interview of Contractual Liabilities (I)",

<http://www.civillaw.com.cn/lawfore/CONTENT.ASP?programid=1&id=292> 6 June 2003.

(a) Tort solution

This part is focused on the issue whether the subsequent building owners' remedies for defective construction should be solved in the proposed reform on third party's right in China and whether it is proper and justified to apply the dual intention test to decide availability of contractual remedies.

(i) Liability for defective construction causing physical damage or damage to property

A contractor's liability for defective construction causing physical injury or damage to the property is regarded as a liability in tort in China. A contractor should be responsible for any personal damage or damage to property not only to the employer but also to the sub-owners or occupiers of the building, even he does not know who will be the sub-owner or occupiers in the future.³⁴⁴ For example, a woman became ill, caused by radiation of building material because the contractor did not have the construction material officially tested before putting it into use. The contractor is liable in tort, whether or not he has a contractual relationship with the woman.

Article 80 of the Chinese Construction Law³⁴⁵ provides that a contractor, subcontractor, designer or construction supervisor who is at fault for the defective construction bears liability for any person who suffers physical damage or damage to the property. The rule is based on the theory in the Chinese Civil Law – every one is in duty bound to take reasonable care to avoid causing other people's physical damage or damage to property. The liability is further described in the Chinese Quality of Construction Work and Maintenance Act:³⁴⁶

³⁴⁴ Wang Tianyi, *Construction Contract and Damages*, (2003) The People's Court Press, p231

³⁴⁵ The Chinese Construction Law was promulgated in 1997, and was brought into effect in 1st Jan 1998

³⁴⁶ Article 14 of the Chinese Quality of Construction Work and Maintenance Act. The Act was promulgated and implemented on 30 June 2000

Within the period of maintenance, the owners, occupiers or other third parties who suffer a physical injury or damage to the property as a result of the defect of the building or other quality problems of the construction work, have a right to claim for compensation from the constructional team. And the constructional team can ask for recourse for other parties at fault (say designer or technical consultant).

Again article 15 provides:

The party who fails to maintain or repair the building on time shall compensate for any physical injury or damage to the property which is caused by delay.

Such liabilities are not created by a contract, but created directly by legislative provisions, which explains why they are treated as tortious. For the same reason the contractor, subcontractor, designer or construction supervisor cannot exclude or limit the liability by contrary agreement.

In English Law, the liability for defective construction did not extend to a third person who had no contract relationship with the builder, even the defective construction caused physical injury. In *Otto v Bolton*,³⁴⁷ the Court of Appeal held there was no liability in the builder for the defective ceiling which injured Ms Bolton. But decisions were made to the contrary in the 1970s and 1980s, beginning with the case of *Dutton v Bognor Regis*.³⁴⁸

In Chinese law, the parties who are responsible for defective construction also include landlords who put out buildings to lease. Similarly, right of action for physical damage or damage to property is not based on the lease contract, but is founded on statutes. Therefore, both tenants and other occupiers are able to sue the landlords

³⁴⁷ [1936] 2 KB 46

³⁴⁸ UDC [1972] 1QB 373 (CA); *Anns v London Borough of Merton* [1978] AC 728; also see Hector L. MacQueen, "Concrete Solutions to Liability: Changing Perspectives in Contract and Delict" (1998) *Arbitration: Journal of the Chartered Institute of Arbitrators* Vol. 64, 285, 286

under the legal provisions.³⁴⁹

By contrast, the English law approach was different. In *Cavalier v Pope*³⁵⁰ the landlord negligently misrepresented the leased premises and thereby caused injury to the wife of the tenant. Her action failed both in tort and in contract. It was held that the landlord owed neither a duty in tort nor a contractual duty. But the position of tenants and occupiers' position are different after the Defective Premises Act 1972. Section 1 of the Act obliges a landlord to ensure that any work that is carried out in his premises is done in a "professional/workmanlike manner" with proper materials. Breach of such a liability and thereby causing physical damage or damage to the property is treated as tortious.

In Australia, the High Court declared that the decision of the *Cavalier v Pope* case is not applied in *Northern Sandblasting Pty Limited v Harris*.³⁵¹ In *Northern Sandblasting*, one of the tenants' children was electrocuted because he touched a tap when he was playing outside. But it was found that one electrician previously had not done maintenance efficiently so that the fuse did not work properly. The court held that the landlord owed a duty to tenants to ensure that the premises they rented were safe prior to the tenant's occupation.

(ii) Liability for defective construction causing pure economic loss

Since the importance of the construction industry in economic development is highly emphasized in China, the contractor, subcontractor, designer and construction supervisor all owe duties to guarantee that the work they have undertaken is done according to general professional and technological standards which are fixed in particular laws, regulations and rules. Breach of these duties and causing pure

³⁴⁹ See the article 21 of the Chinese City Dwelling Lease Regulation, which was promulgated and put into force on 1 June 1995.

³⁵⁰ [1906] A.C. 428 and cf. RGZ 102, 231.

³⁵¹ [1997] 188 CLR 313

economic loss is covered by the provisions concerning damages and compensation.

Such duties are created in general laws, particular laws and regulations – the Chinese Contract Law, Construction Law, and the Quality of Construction Work and Maintenance Regulation.

Liability for quality of construction is prescribed in the Chinese Construction Law. Under article 58, both contractor and subcontractor shall be responsible for the quality of the construction. Article 59 provides that a contractor shall examine all building materials, accessories and instruments according to the design requirements, technological requirements set in related regulations and the contractual terms. Moreover, article 60 provides that a contractor shall guarantee quality of both the toft and building. Such liabilities are further described in the Chinese Quality of Construction Work and Maintenance Act:

A construction company holds a liability of guarantee for keeping his accomplished building in good repair within an agreed or a reasonable period and scope of maintenance.³⁵² The contractor who causes the defect of the building at fault should pay all the fee of maintenance.³⁵³ If the defect is so serious that it brings out the problems of the whole structure and safety, the original designer should put forward a new project; the original constructional team are responsible to rebuild; the original management organization should be responsible for supervision.³⁵⁴

Under the present Chinese laws, the class of defendants includes all parties who violate the duties created by the laws and therefore shall take responsibility for the defective construction, such as contractors, subcontractors, designers and supervisors. On the other hand, their duties are owed not only to employers but also to all the

³⁵² Article 4, Chinese Quality of Construction Work and Maintenance Act 2000

³⁵³ Article 13, Chinese Quality of Construction Work and Maintenance Act 2000

³⁵⁴ Article 10, Chinese Quality of Construction Work and Maintenance Act 2000

people who have or will obtain legal interests in the construction, such as the sub-purchaser, or the owner's family members and tenants. The duty to rebuild or repair also transmits to the same individuals or entities. Under this rule, an employer and his successors are able to sue a subcontractor although there is no contract between them. For example, the sub-owner is entitled to ask the contractor to repair the building or claim repair fee from the contractor. Extension of such liability for pure economic loss is directly founded on the statutes but not on any particular contract, so the nature of the liability is tortious.

The same approach is used in French Law to solve the problems on economic loss caused by defective construction. Like the theory on transmissible warranties of quality applied in sale of products, the French Civil Code also imposes upon builders liability for the defective construction to employers and other people who obtain benefits and interests from employers.³⁵⁵

In English law the House of Lords held that without a contractual relationship, pure economic loss caused by defective construction could not be recovered from builders. On the other hand an exception was established in the Defective Premises Act 1972 – section 1 of the Act imposes upon builders who are involved in the construction of a dwelling a duty to see that his work “is done in a workmanlike manner...with proper materials and so that as regards that work the dwelling will be fit for habitation when completed”. It is argued that pure economic loss caused by violation of such a duty is also covered in this provision, and also such a duty cannot be excluded by contrary contractual terms.³⁵⁶ But the provision is limited in practice because it only applies to dwellings. By contrast, in Chinese law and French law, the liability is not restricted only for dwellings, but to all construction.

(b) Contract solution

³⁵⁵ “French Privity”, 346 et seq.

³⁵⁶ Spencer (1974) CLJ at 319; *Andrews v Schooling*, [1991] 3 All ER 723

(i) Application of the dual intention test in some assumed cases

The question is, together with the present statutes, what the effect will be after the proposed reform in third party rights, and what the result would be in application of the dual intention test. For example, B enters into a contract with company A, who is the contractor, to construct a building. B sells the building to C, who occupied it for a period of time and later one side of the wall collapses, which causes damage to neighbor's building. The accident is caused by defects in the building, but the neighbor is not able to sue for damages on the contract between A and B, although he is able to claim damages from B under article 80 of the Chinese Construction Law and article 14 of the Chinese Quality of Construction Work and Maintenance Act. Similarly, C is not able to sue on the contract between A and B either. However, the situation would be different if the building contract expressly provides that the owner, subsequent owner and occupiers are able to sue on the contract, or provides that A's guarantee of the quality of the building work is also effective to a recognized class of people – these people should be allowed to sue on the contract under the protection of the third party rules.

For another instance, A engages B to rebuild and refurbish his son C's house. The construction work is found defective later. If any physical damage or damage to the property is caused by the defective work, the person, including C, who suffers loss is entitled to sue B in tort. But C is not entitled to claim damages on the contract between A and B. However, if the contract term confers the benefit on C and also C is expressly identified, he will be entitled to sue B for damages on the contract even for pure economic loss.

Under the present Chinese law, where a landlord A enters into a lease contract with B, to let an apartment to B, if the apartment is found defective or is not suitable for habitation, or A fails to perform repair work or decoration work as agreed, only B is entitled to sue A on the contract. But in application of the dual intention test, if A has promised to confer the benefit on B's family members, who have been expressly

is identified, they will have the right to sue A for breach of the contractual terms.

The reasons held by the Chinese courts to support the third party's action have something in common with the German techniques. In the *Li Xuan & Wang Yafang v. Tieda Real Estate Development Corporation*,³⁵⁷ the tenant's wife became ill because of infected water, and the court held that the wife could claim damages under the contract on the ground that the landlord's contractual liability to provide "a qualified-standard habitat including necessary living and working facilities" extended to the tenant's wife. In the German equivalent case, the wife would be entitled to sue against the landlord directly under the protective umbrella of the contract. The German BGB recognises a third party beneficiary's right of action according to article 328 BGB. Sometimes the German courts interpret the provision broadly and expand application, finding in the case about a lease contract, that tenants are assumed to have an intention to benefit third parties, i.e. other members of family, who will occupy the premise together with the tenant. The BGH stated this point in its judgment of 16 October, 1963:³⁵⁸

It accords with the sense and purpose of the contract and the principle of good faith that the only persons to whom the debtor owes his contractual duty of care and protection are those who are brought into contract with his performance by the creditor and in whose welfare and the creditor has an interest because he himself is bound to take care and protect them, like the members of a man's family or the employee of an entrepreneur. To extend the contractual debtor's responsibility in this way is justified because he must know that the safety of the limited and compact group of persons to whom the contractual protection enures is of as much concern to the creditor as his own.

The same opinion was repeated by the BGH in a judgment made on 19 September

³⁵⁷ Ma Qiang, "The Contract for Protecting third parties", www.civillaw.com.cn/research/justice/default.asp 12 Feb 2003; Financial Law Forum, <http://fol.math.sdu.edu.cn/jrfy/content/content.php?id=76&tb=dxal>

³⁵⁸ BGH NJW 1964, 33, 34

1973³⁵⁹ that contracts of lease were prime examples of the application of the legal doctrine of contracts with protective effects for third parties.³⁶⁰ The courts include third parties in the protective ambit of contracts if creditors owe them a duty of care and protection. In the case of leases this applies not only to the tenant's family but also to domestic servants and other assistants who, consistently with the lease, share in the use of the leased property or indeed, as here, use it on behalf of the tenant.³⁶¹

(ii) Suit by owners against subcontractors

An important section in construction business is subcontracting. The provisions regulating relations among employers, building contractors and subcontractors are important parts of the Chinese construction laws. The central questions are: (i) whether owners are able to sue the subcontractors for the defective construction work; (ii) if yes, what the nature of subcontractors' liability to the owner is – contractual or tortious? (iii) to what degree the owners should be compensated.

In the earlier stage in China before 1997, the privity doctrine was applied in the chain of construction – all the parties confine their contractual rights and contractual obligations within the scope of their own contracts, as it was applied in the chain of contracts for sale.³⁶² For example, article 12 of the Installation Construction Subcontract Regulation³⁶³ provided:

Where the head-contractor subcontract his work to the subcontractor(s), he holds contractual liabilities towards the employer; the subcontractor(s) hold contractual liabilities towards the head-contractor.

³⁵⁹ BGHZ 61, 227, 234

³⁶⁰ See BGHZ 49, 278, 279; 49, 350, 353

³⁶¹ http://www.ucl.ac.uk/laws/global_law/german-cases/cases_bundes.shtml?19sep1973 25 Feb 2004

³⁶² Wang Liming "The Privity Principle", [1996] Journal of Chinese Law, issue 4.

³⁶³ The Installation Construction Subcontract Regulation was promulgated on 3 March 1983 and was abolished in 1997.

Article 9 of the Design Construction Subcontract Regulation³⁶⁴ prescribed:

The head contractor has a right to subcontract the design work to one or several designers. The latter hold liabilities towards the head-contractor according to their contract, and the head-contractor should be responsible for the employer according to the head-contract.”

But the situation makes a big change after the Chinese Construction Law was promulgated in 1997. Article 29 provides:

The head contractor is entitled to subcontract with several subcontractors to supply several parts of the construction work respectively. The head-contractor holds contractual obligations to the employer according to the head-contract terms. Each subcontractor holds contractual obligations provided in his own subcontract to the head-contractor. But they hold a joint liability towards the employer.

The Chinese Contract Law 1999 follows the same approach. Article 272 provides:

The head-contractor, under the permission of the employer has a right to subcontract his work to another person (subcontractor). The subcontractor and the head-contractor hold a joint duty towards the employer in respect of their construction work.

However, the question is whether the joint liability is treated as tortious or contractual. If it is contractual, why is such a liability imposed beyond privity? As was indicated above, the owner has the right directly to claim pure economic loss caused by defective construction in tort action against the contractor or subcontractor under the current statutes.³⁶⁵ On the other hand, the joint liability is separately established again in the Chinese Construction Law and the Contract Law. It seems that such a joint

³⁶⁴ The Design Construction Subcontract Regulation was also promulgated on 3 March 1983 and was abolished in 1997.

³⁶⁵ Article 58 of the Chinese Construction Law; article 10 and article 13 of the Chinese Quality of Construction Work and Maintenance Act.

liability is different from the above tortious liability, and it must be considered as contractual. This is because: (i) unlike the liability set up in article 58 of the Construction Law, under articles 10 and 13 of the Chinese Quality of Construction Work and Maintenance Act, the joint liability to employers is not limited for the quality of construction, but includes their failure to satisfy the quality of construction work as required and complete the work on time; (ii) the liability is created in the Construction Law, and later is confirmed in the Contract Law, which means the provision should be applied to all the cases concerning construction contracts and subcontracts; (iii) joint liability of both contractors and subcontractors means that where contractors fail or are unable to compensate owners' loss for some reasons, for example, contractors refuse to compensate owner's loss or contractors are close to bankruptcy, owners also have the right to recover loss directly from subcontractors. Relying on the action on the contract, the owners' expectation interest is therefore included in the protection.

Such a liability beyond privity of contract imposed on the subcontractors is based on the fact that in Chinese construction business, a subcontract is normally fixed when the contract between the employer and the contractor is concluded. The fixed subcontract is expressly identified in the contract, and also the employer's name is very likely to be identified in the sub-contract expressly, so both the employer and the subcontractor know that the construction work is to be done for the employer's benefit. In addition, subcontracts normally provide for the incorporation of the terms and conditions of the main contract. In China, cases happened from time to time where head-contractors colluded with subcontractors to get more benefits than agreed amount in the contract and thereby caused loss to employers. In theory, the imposition of the liability is justified by the end purpose of the construction contract, and the transfer theory in the contract laws – under an obligee's permission, the obligor has the right to transfer his whole or part of the contractual obligations to a third person. Then the third person must perform the obligations and be liable for breach of the

contract.³⁶⁶ Such liability is not founded on the parties' intention but is directly created by the provision, and by the specific language of the construction contract.

In addition, such liability cannot be released by exemption clauses or limitation clauses according to article 52 of the 1999 Chinese Contract Law. By examining the application of the dual intention test, employers would not get a benefit from the reform in third party rules in China. On a construction of a sub-contract, the parties normally intend to keep their contractual rights and obligations within the boundary of their own contracts. If an employers' enforceable right is based on parties' intention, presumption of such an intention is rebuttable only because of the contractual structure set by the parties, unless the intention is explicitly expressed in contracts. On the other hand, the reform will not benefit subcontractors who seek to enforce the exemption clauses in the main contract under some circumstances. Such a right could be rebutted because the validity of exemption clauses is subject to accordance with the provisions of compulsory statutes. Therefore, a subcontractor's obligation to supply a satisfactory quality work, to compensate for the physical injury or financial loss to the employer, to make a repair in time during the agreed period or to shoulder joint liability with head-contracts, cannot be excluded by the parties' contrary agreement.³⁶⁷

³⁶⁶ See article 2 of the Chinese Economic Contract Law (put into force in 1982, and abrogated in 1999); article 84 of the Chinese Contract Law 1999

³⁶⁷ Many liabilities of the contractor are strictly provided in Chinese laws. Even some of these liabilities are also regarded as administrative liabilities or criminal liabilities in addition to contractual liabilities. It is unlikely for the parties to exclude these liabilities though exclusion clauses. Article 73 of the Chinese Construction Law provides: "If the designer of construction fails to supply his work according to the standard quality and security of construction, he will be asked for pecuniary penalty (by the administration authority) ... If his work thus leads to the building is defective in quality, he should repeat his work, repair and compensate for the damages. Where his fault leads to a serious consequence so as to violate the Criminal Law, he should hold the relevant criminal liability". Article 75 provides: "where a contractor fails to perform his obligation of repair or delay in performing it, according to his contract or the construction laws and regulations, he will be asked for pecuniary penalty (by the administration authority); he should compensate for the loss caused by any problem of quality of the ceiling and the wall".

In England, the House of Lords has even extended the subcontractor's liability to cover pure economic loss suffered by the employer. In *Junior Books v The Veitchi Co Ltd*,³⁶⁸ Junior Books employed Ogilvie to construct a warehouse. Ogilvie subcontracted with Veitchi to lay the floors of the building. Later it was found that Veitchi's work was defective, which made repair necessary and caused delay of business. The House of Lords held that Veitchi owed a duty of care and the plaintiff was entitled to recover the loss. But the decision of *Junior Books* should not be considered as a general solution to solve building contract cases. It was argued that the decision was only made on its particular facts: (i) the subcontractor was nominated by the employer; (ii) the subcontractor was an expert at the work of laying floor, and they were aware of the employer's requirements to quality of the work; (c) the subcontractor had knowledge that the defective work would directly cause loss to the employer.³⁶⁹ In 1995, a decision was made to the contrary in *Henderson v Merrett Syndicates Ltd*.³⁷⁰ Lord Goff explained why the employer normally had no right to sue the subcontractor:³⁷¹

I put on one side cases in which the sub-contractor causes physical damage to property of the building owner, where the claim does not depend on an assumption of responsibility by the sub-contractor to the building owner; though the sub-contractor may be protected from liability by a contractual exemption clause authorized by the building owner. But if the subcontracted work or materials do not in the result conform to the required standard, it will not ordinarily be open to the building owner to sue the sub-contractor or supplier direct... For there is generally no assumption of responsibility by the sub-contractor or supplier direct to the building owner, the parties having so structured their relationship that is inconsistent with any such assumption of responsibility.

³⁶⁸ (1982) SC (HL) 244; [1983] 1 A.C. 520

³⁶⁹ Treitel, *Law of Contract*, 10th Ed., 1999, pp562

³⁷⁰ [1995] 2 AC 145

³⁷¹ [1995] 2 AC 145, 195-196

Even after the reform in privity, the building owner will not get the benefit from it – normally he has no right to sue the subcontractor on the subcontract as a third party beneficiary. The Law Commission states that the enforceable right would be rebutted when the second limb of the dual intention test is applied:³⁷²

I

In *Junior Books v The Veitchi Co Ltd*, it may be that Veitchi's sub-contractual obligations, including the obligation to use reasonable care in laying the floor, purported to benefit Junior Books, who were presumably expressly identified as beneficiaries. However, since Veitchi's sub-contract was part of a wider chain of contracts, under which Junior Books' rights for breach of Veitchi's obligations, were to lie against the head-contractor under the head-contract, we consider that the presumption of an enforceable right would be rebutted. Junior Books would therefore have no right to enforce Veitchi's obligations to the head-contractor.

As to the subcontractor's enforceable right on an exemption clause made in the main contract, there is no doubt that a subcontractor can enforce it where the head-contract expressly allows him to do that. This situation falls within the application of the first limb of the test provided in the 1999 Act. On the other hand, judging parties' implied intention to allow a third party's enforceability on an exemption clause is more simple than judging their implied intention to give a third party an enforceable right on a normal clause. This is because a third party gets a benefit through performance of a normal clause, whereas he gets a benefit from an exclusion clause normally through enforcing it. So if contracting parties have an intention to confer benefits of an exclusion clause on a third party, they must have an intention to allow the third party to enforce it. Generally speaking, it could be inferred that where a subcontractor is expressly identified in exclusion clauses, the parties have an intention to create an enforceable right for him, unless the contract indicates somewhere that parties have

³⁷² The Law Commission Law No 242, para 7.47

no such an intention.³⁷³ In this regard, the dual intention test is easier to be applied in relation to these clauses than it is in relation to positive benefits. Where a subcontractor is expressly identified in the exemption clause, he has the right to enforce it. As the English Law Commission recommended:³⁷⁴

Mr C (the third party subcontractor) would succeed under the first limb of our test or, on the basis that the exclusion clauses is a promise to confer a benefit (the exclusion of liability) on Mr C, who is expressly identified by class, under the second limb.

Mixed solutions were reached in the United States with various explanations. In some cases the courts refused to recognize that employers had the right to sue the subcontractors.³⁷⁵ But in other cases, such a right of action was supported, although decisions were based on different theories. Some of them were decided on subcontractors' tortious duty of care to employers³⁷⁶ or subrogation to the rights of the head contractors.³⁷⁷ Some others were decided by application of third party beneficiary law where particular facts were involved in the case.³⁷⁸ A contractual approach beyond privity made the central question – whether the employer is an intended beneficiary or not. Application of the intent-to-benefit test resulted in inconsistent decisions in practice. For example, in *Kaiser Aluminum Chemical Corp. v*

³⁷³ Treitel: 'Hence employer tried to protect their servants or agents by differently worded exemptions clauses, and the cases to be discussed below make it clear that they can now to do so by using appropriate words. There is no objection to this on policy grounds where the clause is itself valid and constitutes a legitimate device for allocating contractual risks and the burden of insurance. The Contracts Bill 1998 will, when it comes into force, provide a relatively simple drafting mechanism for giving third parties the benefit of exemption and limitation clauses' Treitel, *Law of Contract*, 10th Ed., 1999, p581

³⁷⁴ Law Commission No 242, para 7.43, 89

³⁷⁵ *Pierce Assors. Inc. v Nemours found.*, 865 F. 2d 530, 535-539, 3d

³⁷⁶ For example, *Federal Mogul Corp. v Universal Constr. Co.*, 376 So 2d 716, 724 (Ala. Civ. App. 1979); *Driscoll v Columbia Realty-Woodland park Co.*, 590 P.2d 73, 74 (Colo. Ct. App. 1978); *Juliano v Gaston*, 455 A.2d 523, 525 (N.J. Super. Ct. App. Div. 1982), cert. Denie d, 460 A. 2d 709 (N.J. 1983)

³⁷⁷ *National Cash Register Co. v Unarco Indus., Inc.*, 490 F.2d 285, 286-287 (7th Cir. 1974)

³⁷⁸ *Chestnut Hill Dev.Corp. v Otis Elevator Co.*, 653 F. Supp. 927, 930-931 (D. mass. 1987)

*Ingersoll-Rand Co*³⁷⁹ and *Lake Placid Club Attached Lodges v Elizabethtown Builders, Inc.*,³⁸⁰ the courts held that the owners were not intended beneficiaries in the contracts between head contractors and subcontractors. But a contrary decision was made in some other cases such as *Syndoulos Lutheran Church v A.R.C Industries, Inc.*³⁸¹ It was argued that the inconsistent results were just caused by intent-to-benefit test.³⁸²

Since the object of the enterprise in all construction cases is to construct a project for the owner, references to the owner in contracts or other communications between the prime contractor and the subcontractor are not terribly illuminating. The bottom line is that the intent-to-benefit test has left the law in this area unsettled, and the analysis in the cases is most charitably described as picturesque.

In Scotland, from 1980s to 1990s, a line of cases³⁸³ showed that it would not be just and reasonable to impose a tortious liability on the subcontractors in relation to the employers. The argument arose for possibility of application of JQT by commentators: "it may not only be conceptually tidier, but particularly desirable, ... to pursue a contractual solution instead of relying on a delictual solution."³⁸⁴ Back to 1989, in the case *Scott Lithgow v GEC*,³⁸⁵ the plaintiff's claim based on JQT succeeded. The electrical works which were subcontracted to the defendant were found defective. Scott Lithgow, the employer's action in delict was rejected by Lord Clyde but the claim on the contract was supported. The solution of JQT could be considered in the

³⁷⁹ 519 F. Supp. 60, 72-73, S.D/ Ga. 1981

³⁸⁰ 521 N.Y.S.2d 165, 166, App. Div. 1987

³⁸¹ 662 P.2d 109, 114, Alaska 1983

³⁸² Melvin Aron Eisenberg, "Third party beneficiaries" [1992], Columbia Law Review 1404

³⁸³ *Scottish Special Housing Association v Wimpey Construction (UK) Ltd.*, [1986] SC 57; *Norwich City Council v Harvey*, [1989] WLR 828; *Aberdeen Harbour Board v Heating Enterprise Ltd.*, [1990] SLT 416; *British Telecommunications plc v James Thomson & Sons (Engineers) Ltd.*, [1997] SC 59

³⁸⁴ *SME*, vol. 15, para. 846: J. Convery, 'Contractual structure and duty of care'. 1997 SLT (News)

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³⁸⁵ [1989] SC 41 (Lord Clyde)2

cases concerning employers' right to sue for subcontractors' defective work but this requires examination of the contracts from the following three factors: (i) what standard of performance is contractually required of the employer; (b) The defect of the work should be judged by the standards set expressly or impliedly in the contract (c) it could be manifested in the contract that the parties have an intention to benefit the employers.³⁸⁶

In German law, the employer's claim for the subcontractors' defective work is solved by using the theory *contracts with protective effects towards third parties*. One reason for application of it is because of the dearth of German case law, and another reason is that 'it is common practice in the German construction industry to include in the contract between owner and the main contractor a provision by which the main contractor's warranty claim against the subcontractor are assigned to the owner.'³⁸⁷ Such a contractual claim is treated as a favorable approach by reason that where the owner's action on the contract is brought, the subcontractors can set up all defences against the owner which would have been available to him in a suit brought by the head-contractor.³⁸⁸

3.2.3 Liability for professional service

3.2.3.1 Liability to Disappointed Legatees

A group of cases involves a class of third parties who are called disappointed legatees. A wishes to confer a benefit on C at the time of A's death. A enters into a contract with B, a solicitor, to prepare a legal document such as a will to effectuate A's wish. The question is where B fails to perform his obligations so A's will is not going to be

³⁸⁶ Hector L. MacQueen, "Concrete Solutions to Liability: Changing Perspectives in Contract and Delict" (1998) *Arbitration: Journal of the Chartered Institute of Arbitrators* Vol. 64, 287

³⁸⁷ Markesinis, *The German Law of Obligations*, 1997 p280

³⁸⁸ Markesinis, *The German Law of Obligations*, 1997 p280

effective after his decease, whether B owes a duty to compensate C's loss? If he does, what is his liability founded on – contract law or tort law? Under the present laws, should disappointed legatees be included as third party beneficiaries after the reform in privity and what will the result of the application of the dual intention test be?

Different approaches are used in different countries to solve the problem of disappointed legatees' loss. In some countries, the courts held that solicitors owed a duty of care to disappointed legatees so legatees were able to bring actions in tort. By contrast, the courts in some other countries considered that legatees should be treated as third party beneficiaries who had the right to recover loss on the contract. The difference existed in that the decisions were made on the different countries' law, different tests of enforceability or different explanations for the same test.

(a) Tortious Approach

The problem was debated hotly in England. In *Ross v Caunters*,³⁸⁹ the solicitor failed to warn the client about the witnessing requirements of a valid testamentary document, so that the legatee, as the beneficiary of the will, suffered loss of the legacy. Megarry V.C held that the solicitor should compensate the plaintiff's loss because the solicitor owed a duty of care to the plaintiff when he carried out his contractual liabilities. Later the solution was again used in *White v Jones*,³⁹⁰ decided by the House of Lords. Mr Barratt executed a will cutting both his daughters out of his estate after a quarrel with them. Later Mr. Battatt was reconciled with his daughters and intended to amend his will. He gave an instruction to his solicitor to draw up a new will, which would leave each daughter 9000 pounds. The solicitor waited several months before carrying out the instruction, and the new will did not take legal effect before Mr. Barratt died suddenly. The daughters sued the solicitors, arguing that they were plainly foreseeable victims of the solicitors' lack of care, and that accordingly a duty was owed to them under the tort of negligence. The House of Lords held that the solicitor who was

³⁸⁹ [1979] 3 All ER 580

³⁹⁰ [1995] 2 AC 207

retained to draft the will but failed to do so owned a duty in tort to the disappointed legatees, and therefore the legatees were entitled to claim for the value of the lost legacies from the solicitor. The decision of *White v Jones* is one of the English cases which extend the promisor's liability to the third party in tort to recover the latter's pure economic loss.

In the above case, the fact is that the solicitors, under the contract with his client, were liable for failure to complete his contractual liability properly. Based on the facts and nature of the cases, the solicitor should be able to foresee the legatees would get benefits from the will and that they would suffer loss of legacy if the will did not take legal effect, even if the legatees were not mentioned in the contract between the solicitors and clients. In addition, the solicitors must know that there would be no way to remedy the solicitor's negligence after the testator's death. Especially, the solicitors should have been able to anticipate that the testators' essential purpose and expectation to enter into the contract would be frustrated – the result would be that the testators paid a lot of fees to solicitors but for nothing in return. A solicitor's foreseeability is one of the main reasons explaining why he owes duty of care to disappointed legatees. Lord Goff held that after decease of the testator there would be no claim available against him, and the testator's administrator had no interest to sue because the testator suffered no loss. For the above reasons, it was reasonable to assume tortious liability in the solicitor to the disappointed legatees.³⁹¹ The tort approach has received applause from some people. It was not fair if the solicitor owed no duty to the disappointed legatees because if there were no substantial remedies available in this case, the solicitor who negligently failed to provide the agreed service did not have to take any responsibility for it.³⁹² It was also argued that the principle established from *Hedley Byrne* could be used to resolve the legatees' cases based on the same reason – the law should provide reasonable remedies for disappointed legatees where their benefit of legacy was directly damaged by the solicitor's

³⁹¹ [1995] 2 AC 207, 268

³⁹² Treitel, *Law of Contract*, 10th Ed., 1999, p568-569

negligence in providing his professional service to his client, and where the solicitor should have been able to foresee such a loss to the legatees (within the reasonable ambit) would be caused and no remedies was available to the legatees after decease of his client.³⁹³

On the other hand, tortious approach in disappointed legatees' cases has been criticised. Lord Mustill held that the decision of the *White* case should only be treated as an exceptional judgment to avoid an unjust result, and it did not establish a general rule or bring any new theory in tort law.³⁹⁴ He also said that if the legatees' loss could be solved in tort, then tortious actions should be allowed in other similar cases, for example, A employs B for service, and B is totally able to anticipate his failure to perform the contract will directly cause loss to C, then if C was allowed to bring an action in tort against B, then B's liabilities extend too far.³⁹⁵ In addition, the decision of the *White* case is contradictory to the principle of tort law – the tort law does not remedy pure economic loss or expected benefits, especially the expected financial interest getting from performance of the contract. Otherwise, an unlimited number of third parties would be able to claim their loss caused by the promisor's failure to perform the contractual liabilities, and privity doctrine would not function as a result.

(b) Contractual Approach

In Germany, the notion of contracts with protective effects towards third parties is applied in disappointed legatees' cases. It begins from the well-known *Testamentfall* decision in 1966.³⁹⁶ Markesinis listed three reasons which he considered are crucial factors in deciding the case: (i) pure economic loss is not recoverable in a tort action in German law; (ii) the defendant notary must have known that the timely performance of his obligation was of the essence both to the deceased testator and his

³⁹³ Simith and Thomas A Casebook On Contract (10th ed. By Sir John Smith 1996), 281

³⁹⁴ [1995] 2 AC 207

³⁹⁵ [1995] 2 AC 207

³⁹⁶ BGH NJW 1965, 1955; JZ 1966, 141

daughter (the plaintiff who, as a result of the notary's negligence, did not become the sole heiress of her father's estate but took it jointly with her niece according to the rules of 'community of heirs'; (iii) the daughter was the only person likely to suffer damage because of the defendant's non-performance of his obligation.³⁹⁷ In another German case,³⁹⁸ where the plaintiff's prospective benefits in his parents' property were involved in a divorce agreement but the defendant solicitor, in his father's name, waived a right to appeal which caused loss of the plaintiff's benefits. The plaintiff claimed damages for breach of the defendant's duty as attorney. The court held that the usual problem in cases of contracts with protective effects for third parties was whether the victim was someone the debtor could expect to be harmed by a breach of the contract, but this was not the problem in this case. The Court of Appeal nonetheless held that the plaintiff was drawn into the protective ambit of the attorney's contract:³⁹⁹

Now the contract between client and attorney is such, given its nature and structure, that it can only be very seldom, whether one interprets the contract extensively or invokes para. 242 BGB (BGHZ 56, 269, 273; NJW 1975, 977) that the duties it generates can be sued on by third parties, for the fiduciary relationship between client and attorney makes it strongly bilateral and self-contained (references omitted). Thus the fact that third parties have an interest in what an attorney does will not normally lead to any extension of his liability, even if those persons are named or known to him. However, an exception must be made where a contract drafted by the attorney is designed to vest rights in third parties specified therein, especially third parties who, as in the present case, are represented by the client. It is true that most of the cases where the courts have granted third parties a claim for damages arising out of a contract to which they were not parties have involved personal injury or property damage and its consequences (BGHZ 49, 350, 355; NJW 1955, 257), but it is not impossible for a third party to have a personal claim for economic loss caused by breach of subsidiary

³⁹⁷ Markesinis, *The German Law of Obligation, Vol I The Law of Contracts and Restitution: A Comparative Introduction*, (1997) p279

³⁹⁸ BGH NJW 1977, 2073 VI. Civil Senate

³⁹⁹ http://www.ucl.ac.uk/laws/global_law/german-cases/cases_bundes.shtml?19jan1977 25 Feb 2004

contractual duties.

The general remedy rule in tort law does not aim to put the plaintiff back to the position as if there was no promisor's breach of contract happening. But in cases like *White v Jones*, the plaintiffs should be compensated for the value of legacy which they could get from a valid testament. Application of the contractual approach would overcome the above difficulty. However, the House of Lords denied application of the contractual approach in *White v Jones*. Lord Goff considered that although such an approach is attractive but it would incur serious criticism because it would almost demolish the consideration rule as well as the privity doctrine in Common Law.⁴⁰⁰ He held that even if English law had accepted *jus quaesitum tertio*, imposition of a contractual liability upon the solicitor in this case would be beyond the scope of JQT.⁴⁰¹ Lord Keith and Lord Kinkel also held that the consideration rule and privity doctrine should not be abandoned just for obtaining impartial results in some cases.

In America, disappointed legatees are generally allowed to recover against solicitors who have failed to execute their clients' testament properly. However, the foundations of the decisions were mixed – some cases allowed disappointed legatees to claim on a theory of negligence,⁴⁰² but most of them allowed legatees to rest on third party beneficiary theory.⁴⁰³ Application of the third party beneficiary theory is due to a broad explanation of the intention test: either that the testator has a subjective motive to confer a benefit on the legatees as an end, or on the testator's end purpose in entering the contract. It was argued that the reason why the contractual approach was preferable because the testator entered into the contract not to employ an appropriate process, but to achieve a given result, compared to the other cases providing

⁴⁰⁰ [1995] 2 AC 207, 262-263

⁴⁰¹ [1995] 2 AC 207, 262-263

⁴⁰² See *Lucas*, 364 P.2d 688 (under the law of malpractice); *Garcia v Borelli*, 180 Cal. Rptr. 768, 772 (Ct. App. 1982); *Bucquet v Livingston*, 129 Cal. Rptr. 514, 518 (Ct. App. 1976); *Ogle v Fuiten*, 455 N.E. 2d 1344, 1348 (Ill. App. Ct. 1983).

⁴⁰³ *Stowe v Smith*, 441 A. 2d 81, 83 (Conn. 1981); *Hale v Groce*, 744 P. 2d 1289, 1292 (Or. 1987); *Liederbach*, 459 A.2d 753 (Nix, J., concurring); See *Melvin* supra note 83, 1395

services.⁴⁰⁴ The solicitor's failure to perform the contractual obligations totally destroys the testator's expected interest. This explains why the disappointed legatees must be allowed damages of the value of the legacy where there is no action available from the testator.⁴⁰⁵

(c) Recommended solution in China

As has been noted, both tortious and contractual approaches are attractive. But they are also controversial.

First, whether a solicitor's liability to disappointed legatee should be regarded as an exception in tort law is still questionable. If the tort law opened a gate for a third party who suffered pure economic loss as a result of a promisor's breach of the contract, it would create difficulty to decide whether the solution should be used in other similar situations. The problem would be extremely difficult in fixing a line between the cases in which the plaintiff should be allowed to sue in tort and those in which they should not.

Secondly, on the other hand, the decision based on contract law seems a strained interpretation. This is because:

1. In a normal case between a solicitor and a testator, the parties have no intention to confer a benefit directly on the legatees or allow them to enforce the contract. For a testator, normally he does not have an intention to allow legatees to enforce the contractual provisions. In the *White v Jones*, when the testator entered into the contract with the solicitor, he did not expect that the solicitor's breach of contract would cause loss to the legatees and as a result there was no cure available for the legatees to recover from the solicitor. On the other hand, the

⁴⁰⁴ For example, the solicitor was employed to enter into a litigation is not obliged to win the case.

⁴⁰⁵ Melvin Aron Eisenberg, "Third party beneficiaries" [1992] Columbia Law Review 1358, 1395

solicitor's express or implied promise to use reasonable care does not mean to confer a benefit on the third party. Nor is it one by which the solicitor is to enable the client to confer a benefit on the third party.⁴⁰⁶ In other words, the solicitor's original intention to promise to take a reasonable care is to ensure effectuation of the client's will but not to confer a benefit on the third party beneficiaries or create an obligation directly towards them. Even if the intention is explained broadly by using the notions like 'objective performance interest' and 'the promisee's subjective motive in entering into the contract' which have been used in some American cases, it cannot make a conclusion that the disappointed legatees are allowed to enforce the contract. Under the dual intention test, the disappointed legatees normally would not get benefit after the reform in privity unless the contract expressly confers them such an enforceable right. Based on the same reason, the Law Commission states that the reform of English Law is not intended to include negligent will-drafting and analogous situations. In New Zealand, the same conclusion has been made - section 4 of the Contracts (Privity) Act 1982 does not cover the situation where the disappointed legatees sue the negligent solicitor. Cooke J said in the *Gartside v Sheffield, Young & Ellis*⁴⁰⁷ case:⁴⁰⁸

On an ordinary and natural reading of the key s4 of that Act, a prospective beneficiary under a proposed will could not invoke the Act. For the contract between the testator and the solicitor would not itself contain a promise conferring or purporting to confer a benefit on the prospective beneficiary. Putting the point in another way, the solicitor has not promised to confer a benefit on him.

⁴⁰⁶ Law Commission No 242, paras 7.20, p. 82

⁴⁰⁷ [1983] NZLR 37

⁴⁰⁸ [1983] NZLR 37, 42

2. One important fact in the cases is that a testator's purpose in entering into the contract is to make an effective testament so the legatees are able to get benefit from it. Failure of the solicitor's performance of the contractual liability will frustrate such an expectation. However, the purpose of the contract is different from the parties' intention in the contract. The above fact does not explain the solicitor and his client intended that the legatee should have a right to sue the solicitor in these circumstances. As Simon Whittaker said, rather than on any specific intention of the parties, the liability of the solicitor is to be justified by the nature of the duty and the status of the parties to the contract which they did *intend* to enter.⁴⁰⁹

3. The German concept of contracts with protective effects towards third parties' is even wider than American explanations of intent-to-benefit test. A contract may be held to protect a third party even if it was not the aim of the contracting parties to benefit that party, in order to entitle the third party to recover damages for the injury suffered as a result of breach of the contract.⁴¹⁰ This concept may be applied in cases like *White v Jones*, and the crucial factors to apply it are just the ones the English court used to impose a tortious liability: the solicitor is able to foresee that his failure to perform the contractual obligation will cause loss to the prospective legatees, and there will be no cure available after the testator decease. The problem arising from the application of the notion of contracts with protective effect is in what circumstances the objective interests involved permit the inference that the parties have implicitly stipulated a duty of care towards third parties.⁴¹¹ It was argued

⁴⁰⁹ Simon Whittaker, *Privity of Contract and the Tort of Negligence: Future Directions*, (1996) OxJLS 192, 200

⁴¹⁰ Peter Cane, *Tort Law and Economic Interest*, (1996) 2nd ed. 327

⁴¹¹ BGH NJW 1984, 355, 356

that the German courts have over-stretched the notion of contract with protective effect towards third parties.⁴¹²

In China, the testator's will is prepared through a notary public.⁴¹³ As a professional who provides a service with national authorized qualification, the notary public owes a tortious liability to take care to render his services, and compensate loss to his clients under the Chinese laws. The duty in tort is extended to other people who suffer loss as a result of the notary public's negligence in providing his service. The Chinese Testament Regulations⁴¹⁴ provides that the notary public is liable for his fault in making a testament.⁴¹⁵ Under the Chinese Notarization Law,⁴¹⁶ the notary who is at fault in providing services must compensate loss caused to his clients or the parties who have legal interests in the notarial affairs. The clients and these parties have the right to bring an action for damages.⁴¹⁷ Based on the statutes,⁴¹⁸ the disappointed

⁴¹² Markesinis, *The German Law of Obligation, Vol I The Law of Contracts and Restitution: A Comparative Introduction*, (1997) p280

⁴¹³ A notarial organ belongs to the state's organ and its main commission is to confirm on behalf of the state. There are five ways for the testator to finish his will. Under article 17 of the Chinese Inheritance Act: "1. The testator can conclude his will through a notary public; 2, The testator can write the will by himself, as well as sign his name and date; 3, The testator can ask somebody else to finish his will, but in this case the will takes legal effect only after the testator, writer and other eyewitnesses sign their name and date; 4 If the will is conclude by tape record, the will takes effect when there are at least two attendant eyewitnesses; 5 Where in the emergency circumstance, the testator can conclude an oral will, and the will takes effect where there are at least two attendant eyewitnesses. If the testator pulls through the emergency period and change to conclude a written will, the old oral one will be invalid."

⁴¹⁴ The Chinese Testament Regulations was promulgated in 2000

⁴¹⁵ Article 24 of the Chinese Testament Regulations

⁴¹⁶ The Chinese Notarization Law was promulgated in 2005.

⁴¹⁷ Article 43 of the Chinese Notarization Law

⁴¹⁸ The statutes applicable include local regulations and rules. They also describes the notary's liability. For example, For example, article 49 of the Shanghai Notarization Act 1995 provides 'The notary should pay compensation to any physical person, legal person, or other organization who suffers a loss directly due to the notary's negligence or fault or his improper action in preparing legal instruments'. Article 6 of Hu Bei Province Notarization Act 1998 provides that 'the notary should abide by the law, stand by the professional ethics and keep the secrets when he renders his service to a client', and article 24 prescribes 'Where a notary makes a mistake (out of negligence or deliberation) during the process of his service and thereby causes an economic loss to his client,

legatees are entitled to claim damages from the notary public. In application of the rules, the Chinese courts decided that the prospective legatees could recover loss caused by the notary's negligence in preparing the testament. For example, in two cases *Wang Bin v Dongcheng Notary Department*⁴¹⁹ and *Shijun v Dongcheng Notary Department*,⁴²⁰ the notarial deed of testaments was negligently made and was pronounced invalid, so the legatees could not get properties as a result after the testator died. A claim for damages from the defendant was upheld.

This approach – a notary's tortious liability in proving his service is directly and specifically prescribed in statutes – is preferable in China to a third party claim in contract or in the general law of tort. This is because:

1. There are four reasons to impose a liability in tort in China: an action which violates laws, fault, damage, and causation between the action and damage. There is no question here to create a notary's tort liability. The tort approach is preferable not only because of existence of specific statutes, but also because the parties out of the service contract are normally not entitled to sue on the contract based on the fact that the contracting parties normally have no intention making them to enforce the contract.
2. A notary's tort liability is special because his performance in providing service is made on behalf of a state organ with national authorization. His authority generally makes people trust the standard of his service and rely on it. In order to ensure the notary's reliability and their capability of

other physical persons, legal persons or some organizations, he holds the liability to pay them compensation.'

⁴¹⁹ The case was decided in 2005, Chen Ruilian, *Civil Cases Study*, (2006) Zhongshan University Press, p72

⁴²⁰ The case was decided in 2005, Liu Yufeng, *Typical Cases Review – Application of Civil Code and Economic Law*, (2006) Haitian Press, p197

compensation, Notarial Compensation Fund Regulation was proposed in 2002, which gives prominence to notaries' special liability. Therefore, a prospective legatee who suffers loss as a result of a notary's negligence in preparing the testament will recover the value of the lost legacy.

3. Specific statutes concerning particular types of cases are more practical in China. This avoids varying decisions being made in similar cases, and reduces the courts' difficulty in choosing between general provisions or using general basic principles expansively.

3.2.3.2 Liability of Professionals to Third Parties

What are professionals' liabilities in rendering their services? To which class of people are they responsible and to what extent are their liabilities extended? Some of the above questions have been answered by specific statutory provisions in China, especially those professionals who supply important instruments or formulate certificates on behalf of authorities, such as lawyers, accountants, auditors and appraisers. All these people provide services to their clients and the quality of service will normally affect other people's interests. Again, their performance of contractual liabilities is justified by the nature and the social effects as well. In this regard, the scope of people who suffer loss as a result of the professionals' negligence or fault in providing service are entitled to claim damages is wider than the scope of people who should be protected under the contract laws, such as clients or third party beneficiaries who obtain enforceable right based on the parties' intention.

For example, in China all registered accountants must be qualified, and their liabilities are prescribed in statutes. Article 42 of the Chinese Registered Accountant

Act⁴²¹ provides:

Where an accountant disobey this law and thereby causes loss to his clients or other people who has an interest in the accountant's professional services, he should compensate for them by law.

Article 161 of Chinese Securities Law⁴²² provides:

The professional organs or person who provide accounting report form, capital evaluation, or legal consulting document for securities issue or securities transaction should act in line with the professional rules. They should check and verify correctness, veracity and accuracy of all the instruments they provide. Otherwise they should hold a joint liability.

Accountants supply the services of audit, accounting consultation and other relevant activities on request of their clients.⁴²³ It is argued that there are two legal relations created when they supply professional: (i) a contractual relationship between an accountant and his client and (b) a particular reliance relationship between an accountant and the users of the accounting report form.⁴²⁴ These two relationships decide the nature of the accountant's obligations. That is, in the former case, an accountant takes contractual obligations to his client, and the user is able to use any remedial approach for the accountant's breach of contract, while in the latter case, an accountant bears a tort liability to those people whose interests have been damaged by his fault or negligence.⁴²⁵ The different opinion also exists - an accountant's obligation to all the people who suffer a loss should be regarded as

⁴²¹ The Chinese Registered Accountant Act was promulgated in 1994

⁴²² The Chinese Securities Law was promulgated in 1998.

⁴²³ Article 1 of the Chinese Registered Accountant Act. Chinese Registered Accountant Act was enacted on 1 Oct 1993.

⁴²⁴ Miao Jing, "The Liabilities of Registered Accountant to Third Parties", (2002), Law Journal issue no.8, 57, 58

⁴²⁵ Liu Qiao, "Study on Registered Accountant's Civil Liabilities", Collection of Articles on Chinese Civil Law and Commercial Law, Vol. 16, (2000) Jinqiao Culture Press (Hong Kong) Ltd, 108

contractual.⁴²⁶ But this opinion is not favored by the most of scholars.⁴²⁷

Similarly, auditors, lawyers and appraisers' liability towards third parties besides their clients are also, to some extent, specifically prescribed in Chinese statutes, such as the Audit Law,⁴²⁸ Public Bid Law,⁴²⁹ Chinese Quality of Construction Work and Maintenance Act, Company Law⁴³⁰ and many regulations constituted by the State Department. The statutes impose liability on these professionals and enable a certain class of parties outside contracts to recover losses caused by defective services from them.

3.3 Conclusion

One ideal for the Chinese contract law reform is the standard of social congruence. This means all rules, as general provisions, should be established as reasonable, unprejudiced and practicable ones so that they guide properly in all applicable propositions and point out the best way to solve the problems when propositions collide. A second ideal is that the rule accords with the standard of doctrinal stability. Especially in China's multi-layered jurisdictional structure and judicatory situation, more consistent and specific rules which cause less uncertainty in practice are necessary. As concluded in the chapter two, the privity rule should be changed in China and in some certain circumstances third party beneficiaries' rights should be recognised by law if this is required by the nature of a contract, the autonomous will

⁴²⁶ See Chinese Accountant Committee, "Liabilities of Chinese Registered Accountant – Case Study", 5-17

⁴²⁷ Song Jie & Cheng Daqing, "Liability of A Notary for Compensation", (2004) Chinese Judicatory, issue no.3, p65, 73; Wang Chao, "On the New System of Notary's Liability for Compensation", (2003) Tianjing Politics and Law College, issue No.3, p45, 46

⁴²⁸ The Chinese Audit Law was promulgated in 1994

⁴²⁹ The Chinese Public Bid Law was promulgated in 2000

⁴³⁰ The Chinese Company Law was promulgated in 1993. New Company Law after revision was promulgated in 2005

of parties, and the basic aims of the Contract Law. A specific test should be established to fix in what circumstances third parties are allowed to enforce the contract. Such a test must be the one which does not prejudice the parties' interests in contracts, and can be applied in numerous situations but causes as little uncertainty as possible. Comparatively speaking, the dual intention test is the best one to be adopted in China.

On the other hand, under the dual intention test, those third parties who may be allowed to claim damages on contracts for reasons of objective performance expectation, justice or even morality, are not involved as third party beneficiaries to get benefit from the reform. Indeed justice and honesty and trustworthiness are two fundamental principles in the Chinese contract laws, and in practice the courts have ever directly used these principles to impose liabilities on the promisor in order to resolve the problem of third parties' damage.⁴³¹ Whether the principles shall be applied, after the privity reform, to decide a third party's enforceability beyond privity in the absence of the contracting parties' intention. The question may be answered from the following three points:

1. Unlike the contracting parties' intentions, which can be inferred from the contract language and surrounding circumstances, the justice principle and honesty and trustworthiness principle do not provide a practical answer to the question when a third party should be allowed to enforce a contract. They are normally applied under the courts' judgment and discretion. From experience of the German law and the French Law, justice is not an independent criterion to decide whether third party rights should be supported beyond privity, but is a correlative reason to establish those legal notions which are particularly applied to specific types of cases.

⁴³¹ The principle of honesty and trustworthiness means objective good faith which is regarded as a norm for the conduct of contracting parties, see above para 1.2.4.2 and 2.2.1.2

2. It is important to examine in what types of cases the justice principle is required as the basis to extend promisors' contractual liabilities to third parties under different countries' laws. Drawing on their experience and comparison with the solutions to the same and similar problems under Chinese law makes clear whether the justice, honesty and trustworthiness should be included as a test of third parties' enforceability in Chinese law, in which cases and in what degree they should be applied in practice.

3. Third party' enforceability, technically speaking, should not be based on general principles because the application of general principles will lead to uncertainty in practice and also may cause unlimited extension of promisors' liability to third parties. Direct application of the principles requires either a value judgment as to the worthiness for special protection of the third parties' interest or some other specific reasons the principles must be directly used. It is important to keep the third party beneficiaries' right within the parties' intention while the basic principles are applied in some types of exceptional circumstances only, for example, a new legal problem arising from particular facts of a case.

CHAPTER 4

VARIATION AND CANCELLATION

4.1 Guidelines to establish variation and cancellation rules

Unlike the situation where there is no third party beneficiary involved in a contract, contracting parties' freedom to vary or cancel the contracts may be restricted where a third party's right is involved. The question is whether contracting parties are entitled to modify or cancel a third party benefit and enforceable right after the Chinese reform in privity, and if they are, to what extent their right should be allowed? These are the central questions to be discussed in this chapter.

On one hand, according to the principle of freedom of contract, contracting parties have the right to decide whether to modify or cancel the contractual terms or not, and when and how to vary or cancel the contract terms as long as both of them reach an agreement on these matters. The normal case will be that contracting parties subsequently make an additional agreement to vary or rescind the contract or some contractual terms. The Chinese contract laws expressly recognize such a right. For example, article 77 of the 1999 Chinese Contract Law provides that contracting parties have a right to vary the contractual terms if they make an agreement to do so.⁴³² Article 93 provides that under both contracting parties' agreement, they are

⁴³² Old Chinese contract laws gave the same provisions. For example, article 28 of the Chinese Foreign economic Contract provided 'under both contracting parties' consent, the contract can be modified.' Article 26 of the Chinese economic Law provided 'contracting parties are entitled to modify or rescind

entitled to revoke the contract or some contractual terms. In addition, contracting parties have the right to set conditions in their contract for variation and cancellation. For example, in the contract between A and B, A promises that he will pay off the contract price before a certain date, otherwise B is entitled to stop performance of his own contractual liabilities and revoke the contract. Unless A and B make another different agreement, B has the right to cancel the contract without obtaining A's consent if A fails to pay the money before the deadline. Similarly, where according to the contract, B is entitled to stop doing repair work on A's daughter's house and cancel the contract if A fails to pay the contract price before a deadline, B has the right to do so due to A's failure of payment. As provided in article 93 of the Chinese Contract Law, contracting parties can fix preconditions for cancellation of a contract, so that one of the parties is able to cancel the contract when the precondition is satisfied.

On the other hand, a third party beneficiary who has an enforceable right should be properly protected. The argument focuses on the injustice to the third party where a valid contract has engendered in the third party reasonable expectation of having the right to enforce the contract especially if the third party has relied on the contract to regulate his affairs. If contracting parties could modify or cancel the terms concerning the third party's right without restriction, the third party would not have a right which he could confidently rely on. In China, the principle of honesty and trustworthiness is a fundamental doctrine in contract laws. It is established and designed to avoid contracting parties' misuse of their freedom and unjust results. The principle contains two main points: (i) contracting parties shall exercise contractual rights and perform contractual obligations honestly and trustworthily; (ii) contracting parties are

the contract under one of the following situations: 1, the contracting parties make an agreement on it, but modification or cancellation does not damage the state's or social interest; 2, one party is not able to perform his contractual obligations because of unexpected incidence; 3, one party fails to perform his obligations according to the contract.'

responsible for damages caused by misusing their rights.⁴³³ Under the principle, contracting parties shall exercise their rights to modify or cancel terms properly without causing damage to third party beneficiaries.

The conflict arising here is between respecting the freedom of contracting parties to implement their intentions, and on the other hand allowing creation of effective third party rights so that a third party can arrange his affairs with certainty. Compared with the principle of freedom of the contract which focuses on parties' free will, the principle of honesty and trustworthiness restricts parties' freedom in order to achieve a balance of interests and just results. In theory, the principle concerns two relationships: one is the relationship between contracting parties, and another is the relationship between contracting parties and other social units taking part in economic activities, such as collectives and individuals. The function of the principle of honesty and trustworthiness is to balance the parties' interests, avoid damage to third parties' lawful interests, and to achieve just results. In the Chinese academic sphere, argument has remained for several years about which one is more fundamental – the principle of freedom of contract or the principle of honesty and trustworthiness. Although the issue is not regarded as entirely settled, there seems to be an emerging consensus to the effect that the principle of freedom of contract plays a more basic role in the Chinese contract laws.⁴³⁴ It was argued that the principle of freedom of contract is the most important principle which is regarded as “soul” of the Chinese contract laws.⁴³⁵ Contracting parties' right to vary or cancel the contract is regarded as a necessary part

⁴³³ Chen Liwang, “Review on the Value of the Principle of Honesty and Trustworthiness”, <http://www.civillaw.com.cn/lawfore/CONTENT.ASP?programid=4&id=182> 3 July 2003

⁴³⁴ Liang Huixing, “Some Debatable Issues in Drafting the Chinese New Contract Law”, (1996), *Legal Studies*, issue no.2; Jiang Ping, “Marketing – Economy System and Freedom of Contract”, (1993) *China Legal Science* issue no.6; Liu Kaixiang, “Chinese Civil Law in 21st Century”, <http://www.civillaw.com.cn/lawfore/CONTENT.ASP?programid=1&id=385> 20 MR 2003; Jiang Ping & Zhang Chu, “Essence of Chinese Civil Law – Private law”, (1998) *China Legal Science* issue no.6; Jiang Ping & Su Haopeng, “On Culture of Chinese Civil Law”, (1996), *TianJin Social Science* issue no.2; Liang Huixing, *General Study on Chinese Civil Law*, (1996) Law Press, 38

⁴³⁵ Jiang Pin, Chen Hong & Shen Weixing, “The Principles of Freedom of Contract & Honesty and Trustworthiness in Chinese New Contract Law”, (1999), *Zhengfa University Law Review* issue no.1.

of their contractual right and also an important reflection of freedom of contract. However, the people on both sides have the same opinion that freedom of contract does not mean contracting parties are able to exercise their rights without any restriction. Where a third party obtains an enforceable right in a contract under the contract laws, contracting parties will possibly modify or cancel his benefit, or rescind his enforceable right which causes to injustice to him. In theory, the principle of honesty and trustworthiness requires that contracting parties exercise rights of variation and cancellation properly and reasonably without causing damage to a third party beneficiary.

Therefore, the guideline to resolve the conflict between contracting parties' right of variation and cancellation and a third party beneficiary's interest in a contract is that the contracting parties are entitled to modify or cancel the terms freely as long as such variation and cancellation causes no injustice to the third party.

According to the above guideline, two extreme positions should be out of consideration in establishing third party rules in China.

1. Contracting parties are able to modify or revoke contracts at any time, disregarding whether it will cause injustice to third party beneficiaries. This recommendation should be rejected in Chinese contract laws. The most fundamental and important point is that a third party may reasonably rely on a valid contract, but variation or cancellation of the contract may damage his interests. In addition, if contracting parties were able to modify or cancel the contract at any time without any restriction, a third party would get little protection from the contract laws. Based on the same reasoning, the extreme position is opposed in other countries. In England, the Law Commissioners pointed out that if the contracting parties were able to vary or cancel the contract at any time the reform would amount to little more than a procedural device to allow

the third party to sue in his or her own name when for some reason the promisee was not prepared to act, and would not guarantee the third party any right at all under the contract.⁴³⁶ New Zealand Contracts and Commercial Law Reform Committee has the same standpoint 'if reform of the party rule is to have any substantial effect, there must be some limit on the parties' power to vary or cancel the third party beneficiary's rights without the third party's consent, even if it is only to prevent them doing so once judgment has been given in his or her favour.'⁴³⁷

2. The other extreme position would be that contracting parties cannot vary or cancel the contract at any time. Such a strict limit on contracting parties' right would also be rejected in the privity reform. If variation or cancellation causes no injustice to third parties, there seems no reason to explain why contracting parties should be prohibited from changing their original intentions. Under the dual intention test, a third party beneficiary may be the one who does not exist when contracting parties enter into the contract. It is also likely that the third party does not exist when parties vary or cancel the contract. For example, where a father enters into a contract to buy a life policy for his unborn child, no injustice is caused if the father modifies or cancels the contract before his child is born. As a second example, company B promises another company A, in their contract, that A has right to use and develop technology which is owned by B, and A's subsidiary companies will have the same right. No injustice is caused to A's subsidiary companies if A and B vary or cancel the contract before A's subsidiary company is set up. Cases in which third party beneficiaries are not aware of promises are quite normal in everyday life.

⁴³⁶ Law Commission No 242, para.9.7, 102-103

⁴³⁷ Privity of Contract (1981) para 8.3.3.

4.2 Various possible tests

It is necessary to make a further research on specific applicable tests to decide in what circumstances contracting parties are allowed to vary or cancel the contract freely without a third party beneficiary's consent, and in what circumstances they are not. For contracting parties' part, explicit tests give them freedom to vary or cancel the contract freely before the third party's right is crystallised. As far as a third party beneficiary is concerned, under the tests they can avoid suffering loss by obtaining assurance for their rights. The following discussion will be focused on various tests adopted in different countries' laws. The tests to be considered are –

- an awareness test,
- intimation to the third party and delivery of document to the third party,
- an acceptance test,
- a reliance test,
- putting the contract beyond contracting parties' power,
- and, finally, a promisee's death test.

It will be argued that the best approach to be adopted in China with consideration of certainty and justice is the reliance test, subject to the parties' freedom to expressly choose different crystallisation tests. In addition, to notarise contracts will secure the third party's rights in some circumstances, and the third party's rights will also be secured after the promisee's death if his right is vested at the time of the death of the promisee.

4.2.1 Awareness

An awareness test requires that contracting parties should not vary or cancel the contract once the third party beneficiary is aware of the contractual terms concerning his rights. Considering modification or cancellation of contract provisions normally

happens in economic transactions, it seems that prohibition of contracting parties' right, only because a third party beneficiary is aware of the existence of the contract, is too strict. For example, company A orders two tons of ship steel from company B. A promises he will pay for half of the contract price to B's creditor C. Later for some market reasons, A intends to deduct orders by fifteen percent and pay less to C. A's request is approved by B. No injustice is thereby caused if C is merely aware of existence of the parties' original agreement. As another example, A employs B to do some repair work on his daughter's house. In the contract, they make an agreement that the material for laying floor is durable densified laminated wood. Later A found the material's price is over his budget so he makes another agreement with B to change durable densified laminated wood to normal laminated wood. A's daughter suffers no substantial loss, even if she knows of the existence of the contract.

Absence of injustice caused to third party beneficiaries is regarded as a reason to reject "awareness" as a test in England. The Law Commissioners stated that:⁴³⁸

We see variation or cancellation as causing no injustice to a third party, who aware of the terms of the contract, has no wish to take advantage of them or who does not believe that the promise will be performed or that he or she has an entitlement to performance.

By contrast, in Scotland, a third party's awareness of the contract is one of the factors to assure crystallisation of his right. The leading case is *Carmichael v Carmichael's Executrix*.⁴³⁹ A father entered into an insurance contract for his son. Under the contract, the father was responsible for paying premiums until his son's majority, and if the son died before majority, the father could get back premiums; if the son reached majority and took over payment of premiums, the sum assured would be payable on his death to his estate or assignees. The son reached majority but died before paying premiums. Lord Dunedin concluded that there was a *jus quaesitum tertio* on the terms

⁴³⁸ Law Commission No 242, para 9.12, 104

⁴³⁹ (1920) SC (HL), (1920) SLT

of the insurance policy which included provision for a change on the son's majority, and the son's knowledge of the policy and its terms.⁴⁴⁰ The son's executrix's right of enforcement was fixed on the fact that the son was aware of the policy's existence.

Based on the following comparisons, the test of awareness is too strict to be adopted in Chinese law.

First, as mentioned above, in order to protect the parties' freedom in contracts to the maximum extent, the parties should be allowed to vary or cancel the contracts freely as long as variation or cancellation causes no harm to third party beneficiaries. Indeed in many cases, third party beneficiaries, who are aware of the terms of the contract, wish to take advantage from the contracts or believe the contracts will be properly performed, but frustration of such a wish or belief in mind does not cause substantial harm to them. Therefore, although a third party may not arrange his affairs with certainty just with the knowledge of the contract, protection of the parties' right to vary or cancel the contract freely is still outweighed by the third party's arrangement in this case.

Secondly, contracting parties' right to vary or cancel those contract terms concerning a third party's right is not overridden when the latter's right is created. As discussed, a third party's enforceable right is created when contracting parties have an intention to allow it. Irrevocability of the contract is not a condition for creation of the third party's enforceable rights. The argument that irrevocability should be treated as a condition of *jus quaesitum tertio* has been criticized.⁴⁴¹ It was argued that when contracting parties agreed to confer a right on a third party, it was normally irrevocable in the sense that not even the combined wish of the two contracting parties

⁴⁴⁰ The Laws of Scotland Stair Memorial Encyclopaedia, Volume 15 (1996), 534

⁴⁴¹ Sir John Spencer Muirhead considered that irrevocability would be a condition of a consequence of the expression of a *jus in facore* of the tertius, See Roman Law p79. The argument was criticized by McBryde. See W McBryde, The Law of Contract in Scotland (1987) paras 18-21-18-26

could revoke it.⁴⁴² If irrevocability is regarded as a consequence of creation of a third party's right, then the third party's right is crystallised when it is given by the contracting parties whether the third party has awareness or not. Creation of a third party's right and creation of an irrevocable right for the third party are different issues. Only contracting parties' intention decides whether the third party's right is revocable or not when it is conferred. Where a third party's enforceable right is established under the dual intention test but there is no evidence to prove that the parties have an intention to give up their right to vary or cancel the contract simultaneously, the parties should be allowed to modify or cancel the contract even where the third party has known of the contract.

Thirdly, if a third party's awareness is not expressed explicitly, for example, by oral or written communication, or by conduct, it may be hard for the contracting parties to judge whether the third party is actually aware of the existence of contract, especially in cases where the third parties' knowledge of contract does not come from contracting parties' notification. For example, where a father enters into a contract to repair his daughter's house, the daughter may be told about the contract in her favour by her mother who is aware of her husband's wishes. The father later wants to modify the contract and he may not realize that his daughter has known of the contract. In practice, it is unreasonable and unfair to ask contracting parties to investigate whether the third party beneficiary has already known of the contract before they vary or cancel the contract.

4.2.2 Intimation to the third party and delivery of document to the third party

Here the question is whether third parties' right will be secured in contracts if the contracting parties intimate existence of contracts to the third party, formally or informally, or deliver a relevant document to the third party.

⁴⁴² Memorandum No 38 Constitution and Proof of Voluntary Obligations: Stipulations in favour of Third parties, (1977) para 9, 11

Intimation could be made by oral communication – the contracting party informs the third party that the contract is made in his favour by telephone or face-to-face. The most common case is that contracting parties deliver the document to the third party to show the contract in his favour.

In Scotland, intimation and delivery of the document to the third party have been regarded as additional factors for manifesting that a third party has gained an enforceable right in the contract.⁴⁴³ Although the opinion that irrevocability is regarded as a condition of JQT is criticized, it was argued that once intimation is made to a third party or contractual document was delivered to him, the third party would have an irrevocable right as a result.

In order to answer the central question, it is necessary to examine what the contracting parties' intention is for intimation or delivery. The contracting parties may decide that the contract terms concerning the third party's right cannot be varied or cancelled when making the contract. In this situation, intimation to the third party or delivery of document to the third party could be regarded as notification of his irrevocable right. Intimation or delivery does not necessarily mean the contracting parties have an intention to create an irrevocable right for the third party. What parties' intention is should be construed from the contract language and the whole circumstances of the case. Intimation or delivery itself should not be regarded as a test to secure a third party's right.

Unlike the awareness test, contracting parties know exactly where they stand before varying or canceling the contract under the "intimation" or "delivery" test.

⁴⁴³ Lord Dunedin listed various additional factors which convert a term in favour of a third party into a *jus quaesitum tertio*: delivery of the document to the third party; intimation to the third party; put the document out of the power of the original contractors; reliance of the third party on the provision in his favour. (1920) SC (HL) 195

However, the contracting parties' variation or cancellation will not necessarily cause injustice to the third party merely after intimation to the third party or delivery of a document to him. This is because the third party may have no wish to take the advantage from the contract or does not believe the contract will be performed. Or even if he has such a wish, he suffers no loss because frustration of his wish or belief causes no substantial harm to his interest.

4.2.3 Acceptance

A third party, unlike an offeree, is not normally being requested to respond. But once the third party communicates his assent to the contract in his favour, would such a communication secure his right in the contract?

Here it is necessary to fix the definition of 'acceptance'. First, 'acceptance' is not merely a psychological feature. It should be expressed in the form of words, writing or conduct. Without expression an acceptance test would cause the same problem as 'awareness' does – contracting parties do not know where they stand before varying or canceling the contract. In practice, a third party's request that the contract terms cannot be varied or cancelled because he has accepted the contract in his heart although he has not expressed it, is not recognised as acceptance by the law. Secondly, acceptance means communication of assent to contracting parties. Only the expression showing the third party's assent means that he will take advantage from the contract and take action according to the contracting terms.

In Queensland, the third party rights legislation uses "acceptance" by the third party as the test for crystallisation of his right, and defines "acceptance" as "an assent by words or conduct communicated by the beneficiary to the promisor..."⁴⁴⁴ In England, a similar definition is provided in the 1999 Act as "the third party has

⁴⁴⁴ Queensland Property Law Act 1974

communicated his assent to the promisor...and the assent referred to subsection (1)(a) may be by words or conduct...”⁴⁴⁵

Besides English law and Queensland law, American law also treats acceptance as a test of crystallisation of a third party’s right – the third party’s assent to the contract at the request of the promisor or promisee, according to the Restatement of Contracts Second.⁴⁴⁶ The Western Australia Property Law Act 1969 has similar provision: cancellation or modification of the contract is possible at any time before the intended beneficiary has *adopted* the contract, either expressly or by implication.⁴⁴⁷

The French Civil Code article 1121 also adopts acceptance as a test for crystallisation of the third party’s right by providing that the promisee’s right of revocation shall cease once the beneficiary has made it clear that he wishes to avail himself by virtue of the benefit to be conferred on him under the contract. It is pointed out that acceptance by a third party consolidates a right existing from the inception of the contract by removing the promisee’s right of revocation or variation, but does not create a new right to demand the performance from the promisor.⁴⁴⁸ The Italian Civil Code article 1411 par. 2 follows the French rule by providing that the *stipulazione a favore di un terzo* can be revoked or modified by the promisee until the third party declares to the promisor that he intends to avail himself of the stipulation. Some other civil codes also have followed the French example more or less closely such as the Spanish Civil Code,⁴⁴⁹ Argentinian Civil Code,⁴⁵⁰ Brazilian Civil Code,⁴⁵¹ Swiss

⁴⁴⁵ Section 2(2)(a) Contracts (Rights of Third Parties) Act 1999

⁴⁴⁶ Article 311 of the Restatement of Contracts: “(1) Discharge or modification of a duty to an intended beneficiary by conduct of the promisee or by a subsequent agreement between promisor and promisee is effective if a term of the promise creating the duty so provides. (2) In the absence of such a term. The promisor and promisee retain power to discharge or modify the duty by subsequent agreement. (3) Such a power terminates when the beneficiary, before he receives notification of the discharge or modification, materially changes his position in justifiable reliance on the promise or brings suit on it or manifests assents to it at the request of the promisor and promisee.”

⁴⁴⁷ The Western Australia Property Law Act 1969, section II (3)

⁴⁴⁸ International Encyclopedia, par. 13-44, p42- 43

⁴⁴⁹ Spanish CC article 1257 par.2

Civil Law,⁴⁵² Netherlands Civil Code⁴⁵³ and Greek Civil Code.⁴⁵⁴

In China, an analogy is the notion of “acceptance” of an offer in a standard bilateral contract. The definition of it is in article 21 of the Contract Law as “an expression of the offeree that he assents to the offer”. Acceptance of offeree to an offer means that a contract is thereby concluded between the parties and therefore they shall exercise contractual rights and perform contractual obligations seriously. Neither party can vary or cancel the contract unless having obtaining the other party’s consent or some legal conditions are satisfied.⁴⁵⁵

The assent communicated to contracting parties includes various modes of expression. Beside those words such as “agree”, “consent”, “accept” or “take”, other expressions from third parties, which implicitly contain meaning of their agreement based on the construction of the contract, should be regarded as acceptance too. This includes the following four types of situations. (i) The situation where third parties show their intention to one of the contracting parties that they are going to arrange their affairs in accordance with their right. For example, a father enters into a contract to repair his daughter’s house. When the daughter is notified about the contract, she just says “I need to employ a designer tomorrow”. (ii) A third party makes an enquiry or request to contracting parties based on the implicit agreement of the contract. For example, company A enters into a contract for sale with B and promises B to deliver part of the goods to C. After B notifies C about the contract, C calls A asking for

⁴⁵⁰ Argentinean CC article 504

⁴⁵¹ Brazilian CC article 1098

⁴⁵² Swiss CO article 112 par. 3

⁴⁵³ Netherlands new CC Book 6 article 253ss

⁴⁵⁴ Greek Civil Code article 412

⁴⁵⁵ Article 94 of the Chinese Contract Law provides that either contracting parties is entitled to ask to cancel the contract (or contracting terms) under one of the following circumstances: (i) the aim of the contract cannot be attained because of force majeure; (ii) one party explicitly expresses by words or by conduct that he refuse to perform his contractual liabilities before due date; (iii) one party delay in performing his contractual liabilities, and he does not proceed within a reasonable period after the other party’s warning; (iv) other circumstances provided in particular laws.

specific delivery plans such as dispatch time, standard of container and transportation route. (iii) A third party notifies a contracting party about relevant information based on the implicit agreement of the contract. For an instance, in a lease contract between A and B, A promised B to pay rent by instalment and pay the first three months' rent to B's mother C. C was told of the contract in her favour and later notified A her bank information. (iv) Although a third party does not expressly assent when he is told about the contract, he requests performance from the promisor at the same time or later. A third party's words or document delivered to the promisor to ask, remind or press his performance of the contract indicates the third party has accepted the contract in his favour.

As mentioned above, if acceptance was treated as a test, it ought to be put up expressly instead of hidden inside the third party's mind so that the contracting parties could know that. In addition, in order to assure the contracting party would know of acceptance, acceptance must be received by at least one of the contracting parties. In England, the Law Commission rejected the standard posting rule by reason that:⁴⁵⁶

To apply the rule (post rule) that a valid acceptance takes place on the posting of a letter (subject to exceptions) would mean that a third party could crystallise his rights not only without the promisor knowing anything about it but, more crucially, without the promisor even being able to foresee it (because, for example, the promisor did not know that the third party has been come into existence).

If a third party's right is secured when he communicates his assent to contracting parties, the same problem arises here as it does when the awareness test, intimation to the third party and delivery document to the third party test are applied – the third party may not suffer a loss although he has accepted the contract. In China, should the contracting parties be prohibited from varying or cancelling contracts as long as third

⁴⁵⁶ Law Commission No 242, para 9.20, 106

parties have accepted the contracts? To answer the question, it is necessary to value which is more important – to protect the third party's right so as to ensure his expected benefit in contract and help him to arrange his affairs with certainty, or to protect contracting parties' right to vary or cancel the contract to the maximum extent as long as there is no loss caused to the third party. By reviewing the existing statutes and cases, it is found that contracting parties' right of variation and cancellation is not affected by communication of assent from a third party beneficiary.

In insurance contracts, according to the Chinese Insurance Law,⁴⁵⁷ the policy holder is entitled to change the beneficiary in the policy at any time before the policy ends. Article 63 provides that a policy holder or the insured is entitled to change beneficiary and notify the insurer by writing. The insurer shall make a note after receiving the notification. The policy holder shall get consent from the insured before he changes beneficiary.

There is no additional requirement for the insured or policy holder to change the beneficiary. In *Hong Kong Jinlong Ltd. v Baoshuo Insurance Company*,⁴⁵⁸ Hong Kong International Longyun Ltd. entered into an insurance contract for business property insurance for it and its new-established subsidiary company, Jinlong Ltd. Three months later after the insurance contract was made, eighty percent of Jinlong company's shares were sold to Hong Kong Kaili Ltd. At the same time, Jinlong stopped business and were developing a new business arrangement. Later Longyun Ltd. made an agreement with Baoshuo Insurance Company to cancel all the contracting terms concerning Jinlong's benefits. One month later, Jinlong's property was damaged by fire. Kaili Ltd. claimed to cancel the contract and terminated negotiations for Jinlong. Its claim was upheld by the court by reason that transfer of Jinlong Company's shares had not taken legal effect because it had not gotten approval from the authorised organ. Thereafter Jinlong Ltd claimed that cancellation

⁴⁵⁷ The Chinese Insurance Law was promulgated in 1995, and revised in 2002.

⁴⁵⁸ Li Wenhua, *New Contract Law Explanation and Cases Study*, Fa Zhi Press (1999) p126

of its right, as a beneficiary in the insurance contract, was invalid. The claim was successful but the decision was not based on the fact that Jinlong signed a document to agree with the contract. The court held that Jinlong's right could be cancelled by Longyun Ltd. no matter whether Jinlong had accepted such a right. It was held that cancellation was not valid because the cancellation was made by mistake.

In the *Gansu Alms Committee v Changye Ltd*,⁴⁵⁹ Changye Ltd. made an agreement in 1995 with Gansu Alms Committee and promised he would pay five hundred thousand Yuan to the twenty poorest primary schools in Gansu. Later Changye's donation was propagandized in TV news and newspaper. Headmasters of schools sent letters to thank Changye and also showed their appreciation in press conferences. But in 1996, Changye regretted it and refused to pay money. Changye defended against the claim from Gansu Alms Committee by reason that his unilateral donation action could be cancelled and also he was suffering business financial difficulty. After investigation, the court held that Changye was in fact not in financial crisis so he was not able to cancel the contract. Although, generally speaking, the debtor in a unilateral contract of gift is entitled to cancel his promise before delivery of the subject matter of the contract, he is not entitled to do the same in a contract of unilateral donation, due to its nature.⁴⁶⁰ In this case, the commentator pointed out that the beneficiary schools' acceptance did not constitute a reason for securing their benefits and rights in the contract.

I will further discuss the acceptance test from the following three points:

1. In many cases, if the contracting parties' right to vary or cancel a third party beneficiary's right is disallowed by reason of acceptance of the

⁴⁵⁹ Fa Zhi Daily, 15 January 2006

⁴⁶⁰ Article 186 of the Chinese Contract Law provides that the debtor may rescind the contract before transferring of the rights of subject matter of the contract. Where the contract of gift is in such nature as for public welfare or moral obligation in providing disaster or poverty relief, or the contract of gift is notarised, the provisions of the preceding paragraph shall not be applied.

third party beneficiary, it will put the parties in a very disadvantageous situation, especially those parties who do not know the law. This is because in many types of contracts, like insurance contracts, variation or cancellation of third party beneficiaries' right regularly happens, and contracting parties' freedom must be protected by the law, unless the parties themselves choose that the terms are irrevocable when created. For example, A contracted with B to pay C a certain amount of money monthly for two years. If the acceptance test was applied, A would not be able to decrease payment or cancel C's right only because C said he was pleased to receive the money. Similarly, a father A who employed a repairman B to repair his daughter's house. Without his daughter's consent, A could not change construction material or delay B's work according to his new plan only because the daughter had told him she had been expecting the repair work. Again, in a case like *Beswick v Beswick*,⁴⁶¹ where A promised B to pay an annuity to B's wife C in consideration of B transferring the goodwill of the business to him. After the contract was made, B told his wife C about the contract, and C said she was happy to accept the benefit from A. If before B died, he quarrelled with C and intended to cancel C's benefit in the contract, but he could not do that if the acceptance test was applied.

2. It may be argued that the law must establish a further rule to allow contracting parties to reserve their right of variation or cancellation despite an acceptance by the third party, as French law does.⁴⁶² But such a rule intended to protect contracting parties' intention conflicts with its basis in nature because the contracting parties may not have an intention to create an irrevocable right for the third party beneficiary. In other words, the fact that those parties who do not reserve their right of

⁴⁶¹ [1968] AC 58

⁴⁶² International Encyclopedia, par. 13-45, p43

variation and cancellation does not necessarily mean they intend to create an irrevocable right in the third party. Where no express or implied agreement can be manifested from the contract, it should be regarded that contracting parties retain the power to modify or rescind the contract.

3. Here it is necessary to review one of the reasons why the privity doctrine should be reformed – the law of contract purposes to give effect to the expectations of the contracting parties if they intend to confer the benefit on a third party. However, where contracting parties change their original intention and wish to cancel the third party's benefit, recognition of third parties right is no longer severed for this purpose. On the other hand, considering third parties normally organise their affairs on the faith of the contract, the contracting parties' right to vary or cancel the contract should be limited to the extent of not causing injustice to third parties. But injustice to third parties must be sufficiently 'strong'. Acceptance is not a strong enough reason for denying effect to the changed intention of contracting parties. This is because: First, the fact that a third party has accepted the contract does not necessarily mean he believes the promise will be performed or he is legally entitled to performance of the promise, especially in those cases which third parties beneficiaries are very likely to be changed or their benefits are very likely to be modified. To secure a third party's right based on his acceptance would excessively accentuate protection of the third party's right, however, it is not in accordance with the main purpose of the reform. Secondly, where a third party has accepted the contract, the only unjust result caused to him is that he cannot plan with certainty. However, in principle, securing a third party's right so as only to help him be able to arrange his affairs is not prior to effecting parties' intentions.

Based on the above discussion, I do not recommend “acceptance” as a crystallisation test in Chinese third party rules.

4.2.4 Reliance

Where a third party takes an action after the contract is made, that is, he subsequently acts in reliance on the contract, for example, after a third party accepts the contract on the trust that the contract will be performed and he will get the benefit from it, he will possibly do something subsequently, the question is whether the third party’s right is therefore secured.

In theory a third party’s reliance means his conduct is induced by the wish that he will take the advantage of the contract in his favour and by the belief that the debtor will perform the contractual obligations. In English Law, reliance is defined as “conduct induced by the belief or expectation that the promise will be performed or, at least, that one is legally entitled to performance of the promise.”⁴⁶³

Under the English 1999 Act, a contract cannot be varied or cancelled if the promisor is aware the third party has relied on the term, or he can reasonably be expected to have foreseen that the third party would rely on the term and the third party has in fact relied on it.⁴⁶⁴ Reliance is also a test of crystallisation in other countries. For example, in American Restatement Contracts First, article 143 provides that a discharge or variation of the contract shall be valid without the creditor beneficiary’s consent only if the creditor beneficiary does not bring suit upon the promise or otherwise materially changes his position in reliance thereon before he knows of the discharge or variation. American Restatement Contracts Second article 311 provides that the contracting parties’ right terminates when the beneficiary, before he receives notification of the discharge or modification, materially changes his

⁴⁶³ Law Commission No 242, para 9.14, 104

⁴⁶⁴ Section 2 (b) (c), Contracts (Rights of Third Parties) 1999

position in justifiable reliance on the promise or brings suit on it or manifests assent to it at the request of the promisor or promisee.⁴⁶⁵ The New Zealand Contracts (Privity) Act 1982 provides that alteration or discharge remains possible until the beneficiary has materially altered his position in reliance on the promise. Under the Scottish law, reliance by the third party on the contract term in his favour is regarded as one of the factors which convert a term in favour of a third party into a *jus quaesitum tertio*.⁴⁶⁶

4.2.4.1 Conduct induced by the belief of the contract

The third party's reliance should only count if his conduct is induced by the belief of performance of the contract and they wish to take advantage from it. In order to assure this, it is necessary to check first whether the third party is aware of existence of the contract before he acts. Secondly, from the surrounding circumstances, if there is no fact indicating that the third party does not believe that the contract in his favour will be performed, it is understood that the third party's reliance is induced by the belief of the contract. For example, A promised B to give B's little sister C a new mobile phone. C sold her old mobile phone after she was told about the contract. Her conduct is therefore regarded as a reliance on the contract induced by her belief on it. However, the reliance test is arguable if C sold the old mobile phone and bought a new one. A third party beneficiary may do something coincidentally after he knows about the contract, as if his conduct was induced by his belief of the contract but is not in fact.

There is a case in China where a student sued his college for damages.⁴⁶⁷ In 1994, a Guangdong college entered into a contract with Hong Kong Kelun Corporation, and Kelun Corporation promised to fund the college to set up a "Kelun" scholarship for outstanding students who ranked on the top three in each class every year. The student (A hereafter) was told about the scholarship after he entered into the college in 1997.

⁴⁶⁵ American Restatement Second, article 311, *supra* note 17

⁴⁶⁶ *Carmichael v Carmichael Executrix* 1920 SC (HL) 195 at 201, 1920 2 SLT 285 at 289

⁴⁶⁷ http://www.law365.com.cn/law365/news/show_content.jsp?news_id=45209 12 Mar 2006

The second year, the college cancelled the scholarship because Kelun refused to continue funding it. A, who studied hard, said he had relied on the college's promise and thereby claimed for loss of scholarship. Argument was partly focused on whether the college was able to cancel A's benefit after A had relied on the information of scholarship. The college defended by reason that every student was told to study hard, and the fact A studied hard did not mean he was induced by the scholarship because hard working itself in nature was part of students' mission and it was difficult to distinguish whether it was induced by student's sense of responsibility or induced by the scholarship. The commentator pointed out that in such a case, as long as there was no contrary evidence indicating that the student had no intention to rely on the scholarship, it should be considered that he had relied on it.

4.2.4.2 Reasonable Anticipation

In China, it is considered that the principle of honesty and trustworthiness in nature contains the requirements that a third person's reliance should be reasonably protected in some circumstances.⁴⁶⁸ According to the principle of honesty and trustworthiness the contracting parties should be able to know or foresee the reliance of the third party. This requires that the third party's reliance must be reasonable, that is, any person put into the same position will naturally rely on the contract under the same circumstances. Generally speaking, since a third party who is qualified as a third party beneficiary with an enforceable right, has been expressly identified in the contract by name or by class, the contracting parties should be able to foresee that the third party will possibly rely on the contract. What kind of conduct the contracting parties will be able to foresee is not important; what matters is the fact they can foresee reliance of the third party. For example, A enters into a contract with B to promise B he will give

⁴⁶⁸ He Raode, "Close Relationship between the Principle of Honesty and Trustworthiness and Civil Activities", <http://www.civillaw.com.cn/lawfore/CONTENT.ASP?programid=4&id=246> 3 Ju, 2003; Wang Liming, "Some Issues in the Chinese Contract Law", <http://www.civillaw.com.cn/lawfore/CONTENT.ASP?programid=3&id=24> 6 Jul 2003; Wang Donglin, "On Scope of Reliance Damages", (2000) Research and Review (Yanjiu & Zhengming) issue no.8, 41

B's son C a new car. C was told about the contract. He may buy accessories for the new car, may buy travel insurance for his car travel plan or may choose to sell his old car in anticipation of receiving the new one. It is unreasonable or impossible for A to foresee what kind of conduct C will do, but he should be able to foresee that C will do something relying on the contract.

The problem may arise where a third party does not exist or is not specified when the contract is made. In these circumstances, the principle of honesty and trustworthiness requires that if the third party is aware of the contract in his favour,⁴⁶⁹ he should notify the contracting parties once he comes into existence or specified. Based on the same principle, the parties are liable to check whether the third party has relied on the contract before they vary or cancel his benefit.⁴⁷⁰ Where the third party fails to notify the parties, it is presumed that the parties cannot reasonably foresee the third party's reliance.

Reasonable foreseeability of contracting parties is also regarded as a condition for application of the test of *reliance* in England. The Law Commissioners stated that the unilateral nature of reliance causes difficulty where the promisor could not reasonably be expected to check with the third party because the promisor did not realize that the third party had come into existence. The solution is that the reliance test must be qualified so that reliance would only count where, unless the promisor is actually aware that the third party has relied, the promisor could reasonably have foreseen that the third party would rely on the promise.⁴⁷¹

⁴⁶⁹ There is no problem for the parties to vary or cancel the third party beneficiary's benefit freely when the latter does not know about existence of the contract in his favour.

⁴⁷⁰ The principle of honesty and trustworthiness requires that contracting parties shall exercise their contractual rights properly and take a reasonable care not to cause damage to other people. In this regard, the parties owe a duty to check the status of the third party beneficiary before they modify or rescind his right.

⁴⁷¹ Law Commission No 242, par. 9.28, 108

4.2.4.3 Material Change of Position

The requirement that the third party's reliance has materially changed his position was adopted in some countries' law. For example, American Restatement Second article 311 provides that contracting parties' right terminates when the beneficiary, before receiving notification of the discharge or modification, *materially* changes his position in justifiable reliance on the promise.⁴⁷² New Zealand the Contracts (Privity) Act 1982, s5(1)(a) emphasises that the position of a beneficiary must have been materially altered by his reliance on the promise.

There is no further explanation for what the word "materially" means. If the provisions were made based on a broader concept of reliance – the third party is going to act relying on the belief of performance of the contract and wishing to take the advantage of it and the third party has acted relying on that belief and wishing, the provisions must mean to exclude the former situation. Or the provisions were made on the consideration that the third party's position would not necessarily be seriously changed by his reliance, therefore his reliance should only count if change of his position was serious. On the one hand, there is no problem arising from the definition of reliance, as explained above, that reliance means a third party's conduct induced by his wish to take advantage of the contract and his belief that the contract will be performed. Where is no conduct, there is no reliance. On the other hand, once the third party has acted relying on the contract, his reliance should count, whether the reliance has changed his position seriously or not seriously. This is because, according to the principle of honesty and trustworthiness, contracting parties should exercise their contractual rights properly so as not to cause damage to a third person. As damage is not valued as trivial or not trivial, there is no need to check whether the change of the third party's position is material or not. In addition, without further

⁴⁷² Supra note 17.

guidance to distinguish material from non-material change, it would cause difficulty and uncertainty in jurisdictional practice.

Therefore, the requirement “material change of the third party’s position” is not recommended to be added as a condition for the reliance test.

4.2.4.4 Protection of the Third Party’s Expected Interest

A question arises whether a third party should be entitled to expectation damages, where a promise in his favour has become irrevocable because of his reliance but the contracting parties have changed their mind and purport to vary or cancel the promise.

Reform of privity aims to realize contracting parties’ expectation, but on the other hand it also aims to realize the third party’s expectation in the contract. In most cases the two aims are uniform. The test of reliance is designed to secure the third party’s benefit and right in the contract so as to avoid loss incurred by him after he has relied on the contract. Securing the third party’s right aims to realize his expected benefit in the contract, but not to protect his reliance interest. If the third party was confined to recovering his reliance loss only, the test of reliance would not be a test to crystallise the third party’s right in the contract, but would become a test to determine whether the third party was able to claim the loss due to his reliance. In Chinese contract laws, damages are measured according to expectation limit.⁴⁷³ The third party, whose right in the contract is secured, is able to enforce the promise and also entitled to the normal contractual measure of damages in contract laws.

In a Chinese case, where company A entered into a contract with a travel agent

⁴⁷³ The Chinese Contract Law (1999) article 113 provides that one party fails to perform contractual obligation or his performance does not in accordance with the contract terms and thereby causes loss to the other one party. Damages shall include all the loss and expectation interest as if the contract was properly performed.

B for its 20 employees' package travel to south-east Asian countries for 11 days.⁴⁷⁴ The travel fee was 4,500 Yuan per person, and Company A paid for that. According to the contract, B had to arrange everything about the journey such as route, visa application, air tickets, hotel, insurance etc. At the date of departure, 20 employees went to the Shanghai airport, but they could not board because one of them was rejected by the immigration office by reason of his expired visa. B was asked to reapply visa for this person. 20 employees hoped that the problem could be solved as soon as possible so they could take the airplane. However, after Company A was told about the incident, it asked to cancel the journey and claim damages from B. The argument between arose whether Company A was entitled to cancel the contract without consent of the employees, and how employees should be protected. As a result of application of the privity doctrine, employees could not enforce the contract between A and B. But the court finally held that Company A could not cancel the contract without the employees' consent and the employees were able to claim damages for loss of expected interest from Company A by reason that the employees had relied on the contract between A and B. The court did not further explain this decision, but it seemed the court solved the problem based on the principle of justice, as the Chinese courts usually do in practice to avoid unsatisfactory results by applying the privity doctrine. However, if the third party rule was established, it would be very easy to resolve the problem – as third party beneficiaries, the employees' right was crystallised after they had relied on the contract between A and B, so A could not cancel the contract and the employees were entitled to recover their expectation interest.

Here, we may also review the disappointed legatee case where a negligent solicitor fails to make his client's testament valid before the client dies. Many countries such as America and Germany allow disappointed legatees to sue on the contract between solicitors and clients. One of the most important reasons to support

⁴⁷⁴ <http://www.xsbnly.com/info/376-1.htm> 22 Feb 2006

this contractual approach is that the disappointed legatees are able to claim expectation interest from the contract whereas tort law normally does not protect pure economic loss. In fact, every third party beneficiary who has an enforceable right on the contract is entitled to recovery of expectation interest, and such a right is nothing to do with his reliance.

4.2.4.5 Burden of Proof

The question here is who has the onus of proving the status of the third party. In practice, it may be very difficult for the contracting parties to prove that the third party has not relied on the contract. And also it is not easy for them to testify that there is the fact indicating that the third parties' conduct was not induced by the belief of the promise. By contrast, it is easy for the third party beneficiary to prove his reliance on the contract. For example, in the above case concerning the student's scholarship, the student proved that he had relied on the information of scholarship: for example, he changed his routine and extended study time, he bought many books for further learning, he told his classmates he wished to get the scholarship. It is unreasonable and impractical to ask the college to take responsibility to prove that. However, since contracting parties are required to check with the status of the third party before they modify or rescind the contract, they have to prove that they have used all reasonable methods to check with it. Failure to prove that would cause invalidity of modification or rescission.

4.2.4.6 Detrimental Reliance

In England, the Law Commissioners recommend that reliance need not be detrimental. Detrimental reliance, as they defined, means that the third party's conduct in reliance on the promise renders him or her worse off than he or she would have been if the

promise had never been made.⁴⁷⁵ Detrimental reliance is denied because the law aims to protect the third party beneficiary's expectation interest instead of reliance interest. An insistence that reliance be detrimental makes it very difficult to explain why the third party is entitled to performance of the promise, or its monetary substitute in the form of expectation damages, rather than damages for reliance loss.⁴⁷⁶

However, in practice it may be unreasonable or impossible to require the parties to distinguish detrimental reliance from non-detrimental reliance. For example, A promised B he would pay C 1000 pounds. Based on the belief of performance of the promise, C buys some shares, which he would not have risked buying without A's promise. The shares have now doubled in value. C's reliance makes his position better than when the promise was made. On the contrary, if the shares have fallen in value, C's reliance makes his position worse. However, in practice, after the promise was made, the shares' value changes irregularly from time to time. Where the contracting parties change their mind and plan to modify or cancel the promise, they need to check with C's status. Where the shares fall in value, they can vary or cancel the promise, and after a few days where the shares increase in value, they cannot vary or cancel it. This means C's right is not crystallized when he relied on the promise to buy the shares. The test becomes the result of C's reliance – whether he gets positive benefits or his position becomes worse off. In addition, the burden of contracting parties is enhanced, not only because they have to check with whether C has relied on the contract, but also because they have to check whether C's reliance is detrimental reliance. This means they have to watch the shares market. In many cases, it is even impossible to distinguish detrimental reliance from reliance. This is because whether the third party's status improves or worse off cannot be confirmed in a short period of time, or is not clear so different people make different judgments or multiple explanations from different aspects. For example, Company A promised B to give B's subsidiary company C a set of new-technology machines. C then sold its old machines

⁴⁷⁵ The Law Commission No 242, par. 9.15, 104

⁴⁷⁶ The Law Commission No 242, par. 9.19, 105

to D. At the same time, C gave up its original plan to buy a set of machine from E. The old machine was put in operation in D company and finally was burned because of an aging engine, causing a fire in part of B's factory. C avoided accident luckily. Subsequently E's machine was sold to S, who is C's competitor. The products made from E's machine attracted more customers and C lost market profits as a result. In this case, it is hard to say whether D's reliance makes it worse off or improves its status.

It seems the better solution is not to distinguish detrimental reliance and non-detrimental reliance. The mere fact a third party beneficiary has relied on the promise is sufficient to secure his right in the contract.

4.2.5 Put the contract out of contracting parties' power

In the leading modern Scottish case *Carmichael v Carmichael Executrix*⁴⁷⁷, Lord Dunedin held that putting the document out of power of the original contractors, for example, by registration in the Books of Council and Session, is a possible additional factor which would convert a term in favour of a third party into a *jus quaesitum tertio*.

Indeed, where the parties put the contract in favour of a third party out of their control, it indicates that parties intend to create an irrevocable right for the third party. Therefore, the third party beneficiary's right is secured when the parties take actions which make the contract take irrevocable legal effect, such as registration in an authority or notarizing the contract.

In China, notarization of the contract means notarial organs, on behalf of the state,

⁴⁷⁷ 1920 SC (HL) 195 at 201, 1920 2 SLT 285 at 289

prove existence, validity and enforceability of the contract. The results of notarization of a contract are: (i) the contract is officially confirmed and proved; (ii) the contract is enforceable; (iii) the unilateral contract is not to be modified or rescinded by the obligor without the obligee's consent; (iv) the contract document is kept for the record officially and to be used as an original evidence in the relevant litigation.⁴⁷⁸ The Chinese Civil Procedural Law⁴⁷⁹ article 218 provides that where a party fails to perform the contract which has been notarised, the other party is entitled to request the people's court to enforce it. The Supreme Court's regulations on Civil Litigation Evidence provides that a notarial deed can be directly used in the civil litigation, and it has priority among other documental evidence, audiovisual reference materials and witness's oral evidence to prove the same fact.⁴⁸⁰

An analogy in the Chinese contract laws is provisions on a contract of gift – the debtor is normally able to modify or rescind his promise to the creditor, but he cannot do so if the contract has been notarised.⁴⁸¹ This could be adopted in the new third party rule, that is, a third party's right in the contract becomes irrevocable when the contract is notarised.

However, an exception exists where it can be construed from the contract that the contracting parties' purpose in notarising their contract is not to create irrevocable contractual terms. For example, a contract term exists which reserves the parties' right to modify or cancel the contract or the parties set a precondition to make the third party's right become irrevocable. In addition, in some types of contracts, whether the third party has an irrevocable right depends on the nature of contracts and is regulated by specific statutes. For example, in a contract between a testator and a notary, the purpose of the testator to notarise the testament is to effectuate it, not to create an

⁴⁷⁸ Yu Zengjun, 'Operation of Notarisation',

<http://www.cangzhou.gov.cn/shizhidanwei/fangguanju/yanjiuhui/gongzheng.htm>, 23 Feb 2006

⁴⁷⁹ The Chinese Civil Procedural Law was promulgated in 1991

⁴⁸⁰ The Supreme Court's regulations on Civil Litigation Evidence 2002, article 9 and article 77

⁴⁸¹ The Chinese Contract Law 1999 article 186 and article 188

irrevocable right for the legatees.

4.2.6 Promisee's death

In the group of contracts, the contracting parties make an agreement that the third party obtains the benefit after the promisee's death. In these contracts, it is considered that a special test should be applied.

In some countries' law, the test which decides when a third party beneficiary's right becomes irrevocable is the time of the promisee's death. For example, the German Civil Code article 331 provides that if the performance to the third party is to take place after the promisee's death the third party shall in case of doubt acquire the right to the performance at the time of the promisee's death. The Italian Civil Code article 1411 also provides a special rule for these cases - the promisee "can revoke the benefit even by a testamentary provision and notwithstanding that such third person has declared that he intends to avail himself of it, unless, in the latter case, the promisee has waived in writing his power of revocation".

By contrast, some other countries' laws do not provide a special test for this group of contracts. For example, under the French law, rescission and modification solely depends on whether the intended beneficiary has "accepted" the contract.

The question is what test should be adopted in this group of contracts in China. It will be answered based on the following points.

First, the special groups of contracts are normally life insurance contracts, contracts of testament and contracts of gift. These contracts normally contain terms about the promisees' bestowal on the third parties - the third parties can only acquire the benefits after the promisee's death. For example, an insurance contract between A and B provides that C will get a sum of money if A dies within 10 years after the

contract is made. A enters into a contract with B and promises B to give B's son an apartment at the time of his death. B promise A to effectuate A's will which transfers all his property on C after his death.

Secondly, since a beneficiary obtains benefits only at the time of the obligee's death, his benefit in the contract is treated as "expected right", which exists insecurely and changeably and can be modified or rescinded at any time before the obligee dies. Such a feature is emphasized as a rule in the Chinese insurance law.⁴⁸² Similarly, the German Civil Code provides that, in the absence of contractual stipulation to the contrary, the third party's position before the promisee's death amounts to a "mere expectancy", to a *nuda spes* which ripens into an enforceable right only if the third party survives the promisee and the agreement has not been modified or rescinded before the promisee's death.⁴⁸³ Before the promisee's death, the contracting parties have unlimited freedom to change or rescind the agreement and thereby to nullify the beneficiary's position unless a contrary intent has been manifested.⁴⁸⁴

Thirdly, another characteristic of this group of contracts is that the benefit conferred on the third party merely comes from the promisee, and the promisor's contractual liability is normally to help to realize such a benefit after the promisee's death. Therefore the promisee is able to modify or rescind the contract alone without the promisor's consent. Under the Chinese Insurance Law article 63, the policy holder or the insured has the right to change the beneficiary without getting the insurer's approval, although they shall notify the insurer and the insurer shall make a note after receiving the notification. A similar rule is provided in the German Insurance Contract Law – the policy holder's right to name or change the beneficiary is exercised by a unilateral declaration which according to the General Life Insurance conditions established by the life insurance industry and approved by the federal supervisory

⁴⁸² http://www2.zzu.edu.cn/lawc/Article_Show.asp?ArticleID=97 23 Mar 2006

⁴⁸³ German Civil Code article 331

⁴⁸⁴ International Encyclopedia, par. 13-41, p40

authority, must be in writing and must reach the insurer's office in order to be effective.⁴⁸⁵ Moreover, in the contracts of gift or the contract for testament, it is justified that the donors or the testators have unlimited freedom to modify or cancel the beneficiaries' right. For instance, in the equivalent case of *Beswick v Beswick*,⁴⁸⁶ where A promises B to pay an annuity to B's wife C in consideration of the B transferring the goodwill of the business to him, the reasonable solution is that A has the right to modify or cancel terms concerning C's benefit.

Fourthly, the third party beneficiary's right becomes irrevocable at the death of the promisee. Where the contractual provisions on the third party beneficiary's benefit has not been modified or cancelled after the promisee's death, he is able to request the benefits and get remedies if he suffers loss of the benefits as a result of the promisor's breach of the contract. There is a case in China,⁴⁸⁷ where an old man, who lived alone, promised to transfer the ownership of his house to his neighbor's son in appreciation of the neighbor's care for years. The contract was notarised after being made. After that the neighbor stopped looking after the man and even did not show up. The man was angry and tried to cancel the contract. The court held that the man was entitled to rescind the contract before he died, whether the contract was notarised or not.⁴⁸⁸ The situation in this case could be analogous to those where the parties create a precondition or time that the third party beneficiary only gets the benefit after the precondition is satisfied or after the fixed time.

Based on these four points, the better solution to the problem of crystallisation of third party rights in this special group of contracts to be adopted in Chinese law is that

⁴⁸⁵ Bundesaufsichtsamt für das Versicherungswesen. International Encyclopedia, par. 13-41, p40

⁴⁸⁶ [1968] AC 58

⁴⁸⁷ <http://pufa.bjmtg.gov.cn/yasf040.htm> 31 March 2006

⁴⁸⁸ Regulations on Notarisation of Donation which was promulgated in 1992. Article 7 provides that the contract concerning favour of property right of real estate is not enforceable by the creditor even the contract is notarised. The debtor has the right to vary or cancel the contract until the actual delivery of the property right.

third parties would get an irrevocable right after the promisee's death.

4.3 Reservation of right to vary or cancel

The reform of the privity doctrine is based on the central point that the contracting parties' intentions are protected and effectuated by the law. In this regard, not only the answer to the question whether a third party beneficiary is entitled to enforce the contract depends on contracting parties' intention, but also the answer to the question in what circumstances the third party beneficiary's right is crystallised relies on the parties' intention. Therefore, parties have the right to decide when they can vary or cancel the contract or when they cannot, as long as their agreement causes no injustice to the beneficiary. And on the other hand they have the rights to reserve rights of variation and cancellation to preclude application of the statutory tests.

The German solution to the problem concerning crystallisation of the third party's right, stated in Civil Code article 328, looks primarily to the express or implied intention of the parties. In the absence of specific contractual provisions it is to be inferred from the circumstances and especially from the purpose of the contract whether his right arises at once or only under certain conditions, and whether the contracting parties retain the power to annul or modify the right of the third party without his consent.⁴⁸⁹ Austrian Civil Code article 881 has similar rules although it is less specific and provides only that whether and at what time the third person's right arises depends on the agreement of the parties and on the contract's nature and purpose.

Similarly, under the American Law, the power of the promisee or of both contracting parties to modify or cancel the promise is seen as turning primarily on the terms of the agreement, that is, on the intention of the parties as manifested in the

⁴⁸⁹ International Encyclopedia, par. 13-40, p39

contract.⁴⁹⁰

The solution of empowering the contracting parties to decide when the third party's right is secured is in consistent with the Chinese Contract Law's function and requirements to effectuate parties' expected interests. It is also justified on the basic principle of the contract laws – the agreement between the parties is applied with priority and the statutes are applied in the second place.⁴⁹¹ Generally speaking, they have the following rights.

4.3.1 Right to choose the crystallisation test

The parties have a right to decide when the third party's right is secured. The principle of autonomy of the parties' will is embodied in their freedom to arrange their affairs and make any contract provision they wish. The Chinese Contract Law empowers contracting parties to decide the whole content of their contract and also gives contractual terms priority to be applied over statutory provisions.⁴⁹² This explains why the parties should be allowed to lay down a different crystallization test and reject statutory tests. For example, A promises B to pay a sum of money to C, and they make an agreement that C's right is secured once C expressly accepts the promise. Company S purchases Company T and promises T to continue the existing fixed employee's welfare institution. They also make an agreement that the document must be delivered to the employee's union, and once the union approves it and signed the document, S cannot modify or cancel it in the following five years. In both cases,

⁴⁹⁰ American Restatement Second article 311, see *supra* note 17

⁴⁹¹ Jiang Ping, Cheng Hohong & Shen Weixing, "On Freedom of Contract Principles & Honesty and Trustworthiness Principle in the Chinese New Contract", (1999) issue no.1, Journal of Chinese ZhangFa University.

⁴⁹² The Chinese Contract Law article 53 provides "the content of the contract is decided by the contracting parties, and it normally includes the following clauses: (1) name and address of the contracting parties; (2) the subject-matter of the contract; (3) quantity of the subject-matter; (4) quality of the subject-matter; (5) contract price or commission; (6) Date or period, place and manner of the performance (7) remedies for breach of contract; (8) the methods to resolve the dispute".

the third party beneficiaries' right in the contract is secured by communicating acceptance to the parties, instead of the reliance test which should be applied if there is no such particular terms. The parties' agreement can also exclude the application of other tests provided in specific rules. For example, A promises his wife B to buy a car for B's son C (C is not A's natural son) when C attains majority, and once C attains majority, A cannot cancel his promise. The contract is also notarised. In this case, C's right is not secured when the contract is notarised but is secured when C attains majority.

Where there is no explicit expression of a test set down, it could be presumed that the parties did not choose any test, so the statutory test should be applied. This is because: (i) according to the Chinese contract laws, if there is no agreement between the parties on particular issues, the statutes shall be applied; (ii) considering that variation or cancellation may affect the third party beneficiary's interest, the parties should set the test expressly so that the third party is able to know when exactly his right in the contract becomes crystallised; (iii) explicit statement of the test could avoid ambiguous presumptions on the parties implicit intention. In addition it helps to differentiate the parties' genuine intention to secure the third party's right from those which are not. For example, A promises B to build a fishpond for C. They make an agreement that once A starts construction work, the contract terms concerning structure design and material shall not be modified. Since the agreement is created, not in order to secure C's benefit in the contract, but in order to protect A's interest, C's right is not crystallised when A starts the work but is secured when he relies on the contract, unless there is another test expressly fixed in the contract.

Under the German Civil Code article 328 and American Restatement Second article 311, the parties are able to establish a crystallisation test for the third party beneficiary. The difference is where the parties do not expressly set down a test, the German courts will try to find whether there is any test the parties possibly chose impliedly according to circumstances or the purpose of the contract. By contrast, in

the absence of the parties' intention, the American courts will consider that the parties have not chosen any test. Implicit intention about the test would not count in English law, as suggested by the Law Commissioners that only by an express term, should the parties be able to lay down a crystallisation test different from reliance or acceptance.⁴⁹³ Comparatively, the suggestion to require an express intention of the parties is a better solution which causes less uncertainty.

4.3.2 Right to set condition

The contracting parties also have the right to set a condition to secure the third party's right. They can make an agreement that the third party's right is crystallized after the condition is satisfied. Under this agreement, the third party beneficiary's right is secured only after the condition is satisfied, irrespective of his reliance or acceptance. For example, company A promised company B to supply B's subsidiary company C its new products, but under the contract C's right can be cancelled until C extends its market to South Asia. Therefore, C's right is secured only after it has market in South Asia.

The issue of conditional rights has been touched on in the Scottish case *Carmichael v Carmichael's Executrix*.⁴⁹⁴ The father entered into an insurance contract taken over the life of his son. Under the contract, if the son attained majority and took over payment of the premiums the sum assured would be payable on his death to his estate or assignee. The son reached majority but died before taking over the premiums. The question arose whether the condition was satisfied under which the right became enforceable. The House of Lords held that achieving majority was enough by reason that:⁴⁹⁵

⁴⁹³ The law Commission No 242, par. 9.42, p112

⁴⁹⁴ (1920) SC (HL), (1920) SLT

⁴⁹⁵ (1920) SC (HL) 195 at 198, (1920) SLT 285 at 287; Stair Memorial Encyclopaedia, Vol. 15 (1996), par.830 p535

The continued payment is only to be made on each 22nd of October after the 29th October 1915, the date of the assured attaining majority, and during the continuance of this assurance, the payment of the sum assured is to be made immediately after death, which necessarily brings the assurance to an end. The obligation on the company to pay was therefore absolute. The prestation under the condition never became exigible according to its terms.

However, had the son lived and failed to pay premiums after the date in which he was supposed to pay, the conditions set in the contract would not have been satisfied and the son would not have had an enforceable right.

4.3.3 Reservation of the right of variation or cancellation

The contracting parties have the right to exercise all contractual rights freely. This includes right to vary or cancel the contractual terms, including those which are made for a third person's benefit. The contract containing words like "where both parties come to an agreement, any contractual term can be varied or cancelled", "the parties can modify or rescind the contract at any time" or "both parties reserve all the contractual rights in this contract" all indicate that the parties intend to keep the right of variation and cancellation. Such an intention should be recognized by the law for the reason that the parties' intention has priority to be protected over the third party's benefit.

The questions arising here are whether the reservation of the right will cause injustice or damage to the third party whether the reservation violates the principle of honesty and trustworthiness? If it was, would the contractual term reserving the right take no legal effect according to the Chinese Contract Law article 52 which provides

that the term is invalid if it damages a third party's interest.⁴⁹⁶ The answer is no. This is because article 52 is applied to the terms which are made by the parties with a baleful intention to damage a third person, but the reservation clause is made in order to keep the freedom of the contractual right for themselves. The purpose of article 52 is to protect any person outside the contract with a civil status from being famed up, while the third party, as a beneficiary in the contract, is protected from suffering expected interest. The most important point is that the third person's interest is not damaged only because the parties reserve a right to vary or cancel the contract. It is true that the third party may be misled by the contract and thus relies on it, but this will possibly happen only if the third party knows nothing about the reservation clause. In theory, it is sufficient to match up to the requirements of the principle of honesty and trustworthiness as long as the contracting parties have taken reasonable care not to damage the third party's interest for example, the parties tell the beneficiary that his right is revocable or they deliver the document highlighting the reservation clause. The burden of proof is on the parties.

The New Zealand Contracts (Privity) Act 1982, section 6 provides that the parties may not operate such a clause unless the third party knew of it before it materially altered its position in reliance on the promise. From the provision, it could be seen that the contracting parties' right for reservation clause is recognized, and on the other hand the danger to the third party should be avoided. The provision gives the third party the opportunity to consider the fact that it is not guaranteed the right of enforcement before it chooses to rely on the promise. In England, for the same purpose the Law Commissioners give a different suggestion "in line with our basic commitment to respecting the intentions of the contracting parties, and not causing

⁴⁹⁶ The Chinese Contract Law article 52 provides "the contract terms are invalid under the following circumstances (i) a party enters into a contract under another contracting parties' threat or cheat, or the contract terms are contrary to the state's interest; (ii) the contracting parties deliberately collude with each other to enter into the contract and thus damage the state's, collectivity's and a third person's interest; (iii) the purpose of the contracting parties to enter into the contract is illegal; (iv) the contract term violates the public policy; (v) the contract term is inconsistent with the compulsory regulations".

unnecessary uncertainty, we have concluded that this legislation should only go so far as to require that the reservation of a right to vary or cancel is expressly provided for.

By contrast, under the French law, since rescission and modification depends solely on whether the beneficiary has accepted the contract, As far as the question whether the parties are able to reserve the right to vary or cancel the contract is concerned, it was held that if the parties wish to retain such a right, they may protect themselves against an untimely or undesirable acceptance by simply not revealing to the beneficiary the existence of the agreement made for his benefit.⁴⁹⁷ The contrary opinion observed that the French position is not satisfactory: "...if the promisee wishes to reserve a right of modification, why should he be required to keep the contract secret from the beneficiary or to take other precautions to prevent an acceptance he does not desire?"⁴⁹⁸

Another question is if parties reserve the right but they do not exercise it until the third party brings an action, are the parties still able to vary or cancel it at the time of litigation? Generally speaking, the parties have the right to vary or cancel the beneficiary's right at any time before the contract ends if they reserve the right. But the key point is that the third party beneficiary's right of enforcement is exercised at the time he brought an action, and at that moment his right has not been cancelled or modified. Once the action starts, the beneficiary's right is secured - his right is not affected by the promisee's subsequent cancellation or modification. The issue was discussed in the Scottish case *Love v Amalgamated Society of Lithographic Printers of Great Britain and Ireland*.⁴⁹⁹ In the contract the Society provided benefits for the relatives of its members, and there was a provision for changing the contract: that is, the contractual terms are revocable. But the terms had not been changed or revoked when a particular relative claimed a benefit under them. The relative's claim was

⁴⁹⁷ Picard and Besson No.507

⁴⁹⁸ International Encyclopedia, par. 13-48, p46

⁴⁹⁹ 1912 SC 1078, 1912 2 SLT 50

upheld. It was held that the *jus* under a *jus quaesitum tertio* may be conditional, and the condition may be resolute without affecting the validity of the right if it crystallises before the condition takes effect.⁵⁰⁰ In this regard, where the parties reserve the right of variation or cancellation, the third party's right is conditional. Compared to the case where the parties set a condition for securing the beneficiary's right, the beneficiary loses the right originally provided in the contract once the condition is satisfied.

4.4 Judicial discretion to authorise or prohibit variation or cancellation

As discussed above, the third party's right is crystallised after he has relied on the contract, the parties have put the contract out of their control or after the promisor's death if his benefit is vested at that time. The tests are selected based on the major idea that the parties' rights are protected with priority over the third party beneficiary's interest unless exercise of their right causes damage to the beneficiary. The above tests are treated as statutory tests which will not be applied if the parties have a different intention to secure the third party's right.

The problem of courts' discretion arises in dealing the party's right of variation and cancellation. In principle, the Chinese courts have a limited right to decide each particular case according to its circumstances. This is because in China all the courts' decisions must be made directly on the statutes. Decisions of previous similar cases can be referred to but cannot be used as basis of the judgment. In order to enable the courts to solve various problems in different cases, the law gives courts the right to apply similar statutes and the right to apply the basic principles directly, although this becomes less and less necessary with existence of a large group of specific laws and

⁵⁰⁰ W M Gloag, *The Law of Contract* (2nd edn, 1929) pp242, 243

regulations. The typical case in China is that the principle of honesty and trustworthiness is directly applied by the courts, but this only happens in exceptional situations. In one case, a grandfather A promised his grandson B to buy a house for B and he would pay ninety percent of the house's price while the grandson should pay the rest. Under the agreement, the grandson would get the property right, and if he got married his prospective wife C could also get the property right. The grandfather spent almost all his savings to pay for the house. He and the grandson lived together after purchasing the house. Later the grandson got married. His wife got the property right but she asked the grandfather to move out. The grandfather claimed to cancel C's right. The claim was supported by the court. It was held that the grandfather had an implicit intention to set a condition for both B and C's property right in the house – he has the right to stay in the house for the rest of his life. C's right could be cancelled if she failed to satisfy such a condition. The interpretation of the intention was based on the fact: (i) the grandfather used almost all of his savings to buy the house; (ii) the grandfather did not own another accommodation, so if the grandfather moved out of the house, he would have no place to stay.⁵⁰¹

On the other hand, the courts' discretion is embodied in their right of contractual interpretation. The purpose of interpreting the contract is to construe the genuine intention of the parties from the contract language and the surrounding circumstances. Interpretation of the contract helps the courts estimate the parties' true intention on when they wish the third party's right to be secured or whether they wish to reserve the right of variation and cancellation. As discussed, in those cases where the parties wish to choose a different test from the recommended statutory tests or set a condition to secure the third party's right, the parties are required to lay it down expressly. Where the parties do not expressly reserve the right of variation and cancellation it does not mean the parties do not have such an intention. If it could be construed from the contract and circumstances that the parties have an implicit intention to reserve the

⁵⁰¹ http://hsb.huash.com/2005-12/27/content_2475940.htm 2 Mar 2006

right, it should also be recognized.

The German law gives the courts a more flexible discretion. The questions when and how a third party's right is crystallised depend on contracting parties' intention. If no such intention exists, the judges determine from the circumstances, particularly from the purpose of the contract, whether the parties are to be considered as having retained a power to annul or modify the beneficiary's right without his consent.⁵⁰² There is no statutory test such as reliance and acceptance provided in the German law. But it was argued that there is nothing in German law which would prevent the judge from taking these factors into account. A material change of position by the beneficiary, his assent to the contract or the unfairness that would result from disappointing the beneficiary's justifiable reliance may well constitute "circumstances" to be taken into consideration under German Civil Code article 328 par. 2.⁵⁰³

The German solution is attractive but it causes too much uncertainty. Comparatively a better way to be taken in Chinese Law is to establish concrete guidelines instead of largely depending on the courts' determination. The discretion should be limited to very exceptional cases.

The New Zealand Contracts (Privity) Act 1982, section 7, gives the court a discretion to authorize a variation or discharge the contract "if it is just and practical to do so", despite material reliance which would otherwise have crystallised a third party's rights.⁵⁰⁴ In some circumstances, the parties wish to vary or cancel the contract, and they have to check whether the third party has relied on the contract, or contact the third party for his consent. However, the parties' wish may be frustrated, for example, the parties cannot check with the third party's status or contact him because

⁵⁰² International Encyclopedia, par. 13-50, p47

⁵⁰³ International Encyclopedia, par. 13-50, p47

⁵⁰⁴ The Law commission No 242, para 9.48, 113

they cannot find him. The third party refuses to let the parties know whether he has relied on the contract, or the third party is mentally incapable to communicate his consent. In the above cases the courts should be given a discretion to authorise variation or cancellation. According to the English Law Commission's recommendation, if the parties cannot reasonably ascertain the third party's status or the third party's consent cannot be reasonably obtained, the contracting parties' wish to vary or cancel the contract could be granted by the court. The 1999 Act follows the recommendation.⁵⁰⁵

The court or arbitral tribunal may, on the application of the parties to the contract, dispense with any consent that may be required under subsection (1) (c) if satisfied that it cannot reasonably be ascertained whether or not the third party has in fact on the term", and "if the court or arbitral tribunal dispense with a third party's consent, it may impose such conditions as it thinks fit, including a condition requiring the payment of compensation.

The solution in Chinese Law could be that the law explicitly allows contracting parties to vary or cancel a third party's right if they have difficulty in checking with the third party's status or communicating with him for his consent. However, if the third party brings an action to claim expected benefits on the original contractual terms and claim damages caused by his reliance on it, the parties bear the burden of proof to testify that they have tried in all reasonable ways to check with the third party or contact him. If the parties fail to prove it, variation or cancellation would be invalid as a result.

4.5 Conclusion

Based on the purpose of the reform in privity, the requirements to establish a new

⁵⁰⁵ Section 2(6), Contract (Rights of Third Parties) Act 1999

third party rule in China, and also on the experiences of other countries' law, reliance is recommended as a statutory test to crystallize a third party beneficiary's right in the contract. In addition, it should provisionally prescribe that a third party's right is secured when the parties put the contract out of their control, or after the obligee's death where the beneficiary's right is vested at the time of the death of the obligee. The above crystallisation tests could also be provided in detail in specific laws, such as notarization laws, insurance laws and inheritance laws. On the other hand, the application of the principle of freedom of contract justifies the contracting parties to choose a different crystallisation test, or set a condition to secure the beneficiary's right as long as they lay down their choice expressly. The parties can also reserve the right to modify or rescind the beneficiary's right if such an intention is explicitly expressed or can be construed from the contractual language and the surrounding circumstances. In order to protect a third party's interest, the principle of honesty and trustworthiness requires contracting parties to take responsibility to prove that they have checked the third party's status or communicated him for his consent in all reasonable ways before they vary or cancel the contract. Failure to prove this causes invalidity of variation or cancellation and obligation to compensate the third party's loss. In practice, the Chinese courts would have a limited discretion in deciding whether the parties can vary or cancel the third party's right or not only in exceptional cases.

CHAPTER 5

DEFENCES, SET-OFFS AND COUNTERCLAIMS AGAINST THE THIRD PARTY

In the preceding chapter, discussion has been focused on the problem whether the contracting parties, after entering into a contract for the benefit of a third party, can subsequently vary or cancel the contract after the privity reform in the Chinese contract laws. The argument arose basically on the contradiction between protecting the parties' freedom to modify or rescind the contract and protecting the third party beneficiary's interest in the contract. This chapter considers the issue – where a third party brings an action based on the contract, whether the obligor is able to defend, set-off or even raise a counterclaim against the third party. Again, it is necessary to find a solution to satisfy both the contract law's purpose to protect the obligor's right and the third party beneficiary's interest.

The discussion will be divided into five parts: validity of third parties' enforceable right; validity and enforceability of contracts, obligees' activities, third parties' activities; and some special cases. Each part will focus on the factors deciding what defences, set-off or counterclaim third parties may encounter with when they bring actions.

5.1 Validity of a third party's enforceable right

As demonstrated above, a third party is entitled to bring an action in his own name only where the “test of enforcement” is satisfied. Therefore, where a third party sues against the promisor on the contract, the courts or arbitral tribunal should decide first whether the third party is qualified to enforce the contract. The obligor can also prove with evidence that the third party has no right to sue under the test of enforcement.⁵⁰⁶ The third party’s right of action is subject to the specific contractual provision or specific fact which proves that the parties originally do not have an intention to allow the third party beneficiary to enforce the contract. For example, A promises B to deliver the goods to C directly, C has the right to receive the goods but he does not have the right to enforce A’s promise if the contract contains a provision providing A has to pay liquidated damages to B if A fails to perform promises.

A third party’s enforceable right is also subject to a obligor’s defences such as the condition is not satisfied if the contract confers conditional right on the third party, or the third party’s right has been cancelled before he brings an action. Therefore, a third party who is supposed to obtain the benefit when he reaches majority has no legal right to enforce the contract before his majority.⁵⁰⁷ Again, where A promises B to pay

⁵⁰⁶ There are various situations if a third party is proved not entitled to sue. The first situation is that the original contractual content and test of enforcement decide he has no right of action in his own name. The second situation is that a third party was able to sue at the beginning but he lost such a qualification for the contract is modified or cancelled before the ‘crystallisation test’ is satisfied. Or the third party become unable to sue in that the whole contract or those contractual terms from which the third party’s enforceable right derives are cancelled or modified before the ‘crystallisation test’ is satisfied. The promisor’s defence based on above reason is not included in the narrow defence theory in China, whereas the contrary opinion was also expressed: “In the preceding sections we have discussed the problem whether promisor and promisee, after entering into a contract for the benefit of a third party, can subsequently modify or annul it so that the promisor will have a valid defence if suit is brought against him by the third party.” See International Encyclopaedia of Comparative Law – Third Party Beneficiaries, p47

⁵⁰⁷ This was discussed in chapter four. See *Love v Amalgamated Society of Lithographic Printers of Great Britain and Ireland*, 1912 SC 1078

a sum of money to C, or to another person under B's instruction, before the agreed payment date, C's right to enforce A's promise is subject to A's defence by reason that C's enforceable right is not secured at the time of action. However, where the parties have reserved the right to cancel the third party's right but have not done it when the third party brings an action, such a defence is no longer available to the obligor because the third party's enforceable right is secured at the time of bringing the action.

The discussion in the Law Commission and articles written by American scholars⁵⁰⁸ about the problem of defences begins with the premise that the third party has a valid enforceable right. To extend the scope of defence based on validity of the third party's enforceable right is based on the broad theory of *defence* in China. There are two opinions prevailing about the definition of defence. One opinion defines "defence" as a defendant's right to counteract the plaintiff's claim for implementation of the contract or for compensation so as to lessen or extinguish the latter's claim.⁵⁰⁹ The premise of defence is that the claimant's right to claim exists and is also valid. The aim of exercising the right of defence is to frustrate a claim or postpone its effectiveness.⁵¹⁰ Another opinion states that defence means all defendants' rights which would possibly frustrate claims, postpone or dismiss them by the courts or arbitral tribunal. Therefore, in addition to all the rights of defence mentioned in the first definition, *defence* in the second definition also includes a defendant's right to deny the effectiveness of the claim itself. Where a plaintiff brings an action based on a contract, the reasons such as the plaintiff is not qualified to bring an action or his action does not take legal effect are available to the defendant.⁵¹¹ The broader

⁵⁰⁸ Melvin Aron Eisenberg, "Third Party Beneficiaries", [1992] Columbia Law Review 1358

⁵⁰⁹ Here the "claim" is a general notion which means both the promisee's legal right to ask for the promisor's promised performance according to the contract at any time after the contract is concluded and the promisee's legal right to ask for the promisor's performance or compensation through legal action if the promisor does not perform or perform properly.

⁵¹⁰ See Zhang Dongjiang, "Restriction on Defences in the Performance of A Contract", (2000) 2, GuangDong Social Science 122; Laing Huixing, "General Study on the Chinese Civil Law", (1996) Law Press, 527

⁵¹¹ Wang Jiafu, "Obligations of Civil Law", Publishing House of Law (1991), 401

definition is more appropriate to be adopted in the research because in this chapter it not only aims to discuss a obligor's right of defence but also proposes to study what defences a third party may encounter if he brings an action on the contract.

The reform of the third party rule aims to effectuate contracting parties' intentions and expectations in the contract, and to balance their interests and third party beneficiaries' interests as well. The basic principles, the principle of freedom of contract and the principle of honesty and trustworthiness,⁵¹² are also very important in regulating and deciding the cut-off point between the obligor's right of defence and the third party's right of claim. On one hand, since a third party beneficiary's right of action is recognised by the law, the law ought to protect his benefit in the contract through allowing him to bring an action. The third party is a beneficiary who owes no contractual liability to the contracting parties. The third party's status shall not become worse off because of the obligor's defences. Similarly, the law shall prevent injustice caused to the third party beneficiary. This gives the obligor the burden to prove the reasons of defences. Without sufficient evidence or convincing reasons, the obligor's defence will not be supported by the court. For example, where a third party who had relied on the contract brings an action, the obligor defended by reason that the third party refused to notify his reliance before his right had been modified. Such a defence will not be accepted by the court until the obligor can prove that the parties have checked with the third party before modifying his right. Similarly, if the parties confer a conditional right on the third party, the obligor's defence would not be successful if he fails to prove that the condition has been expressly stated to the third party. Obviously, it is not fair to make the third party's claim subject to it if the third party never knew about the existence of the condition. On the other hand, limitation on the obligor's defence may cause injustice to him. There is no reason to deny the obligor's right of defence only because it is the third party beneficiary who enforces the contract. The most important point is that normally neither an obligor nor an

⁵¹² The principle of honesty and trustworthiness means objective good faith which is regarded as a norm for the conduct of contracting parties, see above para 1.2.4.2 and 2.2.1.2

obligee has an intention to confer on the third party any particular privilege to exempt his claim from defences, unless such an intention has been expressly provided in the contract.

5.2 Validity and enforcement of the contract

The third party's right is created by the contract and his claim for the benefit is based on the contract too. The existence of a valid and enforceable contract is the precondition for the third party to bring an action. A third party's claim is therefore subject to a defence on the ground that the contract takes no legal effect. Similarly, if only parts of a contract are valid but other parts of the contract are invalid, only if those contractual terms from which a third party derives his benefit and right of action are invalid could this be used by the obligor to defend against the third party.

5.2.1 Contracts awaiting being validated

A group of contracts existing in the Chinese Contract law are those which have been concluded already but take no legal effect in that the contracts lack requirements of validity.⁵¹³ These contracts will become effective only after authorized ratification. The reason why some contracts await being validated is because contracting parties lack capacity, or the right to enter into the contract as an agent, or management

⁵¹³ A lot of Chinese scholars have expressed their opinions that a contract comes into being is different from the contract takes legal effect. That a contract comes into being means that contracting parties finish the whole process of offer and acceptance and they reach an agreement finally. However, whether the concluded contract will take legal effect depends on whether the contract meets with all the requirements provided by the law. See Su Huixiang, "Establishment of A Contract & Validity of A Contract", (1990)2 Legal Science (The Northwest University of Political Science and Law); Wang Liming & Cui Jianyuan, New Study on the Chinese Contract Law, (2000) The Chinese Zhengfa University Press, p237

capacity.⁵¹⁴ Under the Chinese Contract Law, the following contracts shall be subject to ratification:

1. The contract made by the parties without full capacity becomes effective only after the legal guardian's ratification, unless the contract is simple enough so it could be made and performed reasonably by a party of corresponding age, intelligence and state of mind.⁵¹⁵
2. An unauthorized activity of agency has no legal effect on the principal, unless it is confirmed subsequently by the principal.⁵¹⁶ The counter-party of the contract can inform the principal to ratify the contract within a month. If the principal keeps silence on it, it will be regarded as ratification being refused.⁵¹⁷
3. A contract is made as a result of a party's activity to manage the property without qualification. For example, A rented a house to B, but B sold the house to C. B's act of sale will not take legal effect unless under A's ratification or under the condition that B obtains a legal right to sell the house, for example, B has bought the house from A after he entered into the contract with C, or was authorized to sell the house as A's agent.⁵¹⁸

Before a contract awaiting being validated is ratified by an authorized person, the

⁵¹⁴ Wang Liming & Cui Jianyuan, *New Study on the Chinese Contract Law*, (2000) The Chinese Zhengfa University Press, p295 On the one hand, since the defect causing the contract invalid is not beyond retrieval, it is possible for the contract to become effective through the authorized person's confirmation. For example, a contract which is concluded by an unauthorized agent will take effect after the principal's subsequent recognition. On the other hand, that a contract takes legal effect with an authorized person's subsequent confirmation will not vitiate legal rules and social public policy, and may it will cause more transactions and realization of the parties' benefits.

⁵¹⁵ Article 47, Chinese Contract Law 1999

⁵¹⁶ Article 66, Chinese Civil Law 1986 and article 48 of the Chinese Contract Law 1999

⁵¹⁷ Article 48, Chinese Contract Law 1999

⁵¹⁸ Article 51, Chinese Contract Law 1999

obligor is able to defend against the third party's claim, even if the obligor himself is the person who has limited capacity. The obligor also has the right to ask for stay of the proceedings of the third party's claim until the statutory deadline of ratification. A contract awaiting being validated may possibly be terminated before it is ratified. This is because the law empowers the innocent counter-party to cancel the contract at any time before the contract is ratified.⁵¹⁹ Therefore, the obligor can defend against the third party's claim on the ground that the contract has been cancelled.

Under the Chinese Contract Law, once the contract is confirmed invalid or void, the result would be that all performance of the contractual liabilities should be denied as if the contract had not been performed. If the property is not necessary or impossible to be returned, it ought to be returned by converting its value into money. The party at fault shall compensate for another party's loss. Where both contracting parties are at fault, each of them holds a liability to make compensation according to their own fault.⁵²⁰ This rule is also applied if a third party beneficiary has relied on the contract. If the third party's claim is subject to obligor's defences by reason that the contract is not enforceable, he is entitled to claim for recovery of the loss caused by the obligor's fault.⁵²¹

⁵¹⁹ See article 47, Chinese Contract Law 1999

⁵²⁰ See article 58, the Chinese Contract Law 1999

⁵²¹ It is generally considered that the contracting parties' loss caused as a result that the contract is confirmed invalid, must be compensated for by the party at fault. This is because although there is no expectation interest existing due to the invalid contract, the party may suffer a loss of reliance interest for his belief that the contract should be effective. His reliance interest includes all the payment to enter into a contract, the payment prepared to perform the contractual obligations and exercise the contractual rights honestly and reasonable indirect loss. See Mei Ruiqi, "The Legal Effect of A Null Contract or A Voidable Contract", <http://www.civillaw.com.cn/lawfore/CONTENT.ASP?programid=4&id=270> 2 Sep 2003; Sha Di, "Formation, Entry-into-force and Effectiveness of A Contract", <http://www.civillaw.com.cn/lawfore/CONTENT.ASP?programid=4&id=277> 2 Sep 2003; Zhao Yanmin & Zhang Yingwen, "Liabilities Arising – after A Contract Is Formed and before It Takes Effect", (2001) 3, Journal of the Gansu University of Politic Science and Law, 71; Wu Weixing, "Liabilities Arising From Concluding A Contract", (2002) 1 Journal of Civil Law and Commercial Law, 41

5.2.2 Invalid Contract

A contract will take no effect if it does not meet with the requirements provided in the Chinese Civil Law article 55. These requirements are: (i) contracting parties must have capacity to enter into a contract; (ii) the contract reflects true intentions of the contracting parties; (iii) the contract complies with the laws and public policy; (iv) the contract is concluded in the required form.⁵²² Except where the first requirement could be satisfied with subsequent ratification, failure to satisfy the other three requirements will lead to invalid contracts. The third party's claim would be subject to the obligor's defence on the grounds of invalidity (lack of true mutual intentions, illegality or lack of formality). Again, article 52 of the Chinese Contract Law provides that the contract or contractual provisions shall be invalid under any one of the following circumstance:

1, the contract term is concluded under one of the contracting party's threat or cheat so that the contract term actually damages the state's interest; 2, the contract is concluded by the contracting parties who deliberately collude with each other to enter into the contract and thereby leads to the state's, collectivity's and any third party's interests are damaged; 3, the purpose of the contracting parties to enter into the contract is illegal; 4, the contract violates the public interest; 5, the contract term violates the compulsory regulations.

Similarly where the third party seeks to enforce an exemption clause or a limitation clause, his claim is subject to defences if these clauses fall within the scope of article

⁵²² Article 56 of the Chinese Civil Law provides this in detail: "The civil legal act is exercised in written, in oral or other manners, unless there is special requirement in the particular laws." Again article 44 of the Chinese Contract Law says "Where there is particular requirement that a certain contract will take legal effect only after the contracting parties finishing authoring or registering legally." For example, the Chinese Contract Law (art. 270) provides that a construction contract shall be concluded in written, otherwise the contract will not take legal effect. The Chinese Patent Law 1985 (art. 10) says that assignment of patent right shall ask for grant of patent organs, so a contract for assignment of patent right will only take effect after being authorized.

52. More specifically, under article 53, an exemption clause is invalid if it exempts a party's liability to compensate another's physical injury, or it exempts a party's liability to another's loss of property due to the former's deliberate intent or gross fault. Once a contract is confirmed invalid, it would be regarded as invalid *ab initio*.⁵²³ A third party's enforceable right arising from an invalid contract would accordingly be seen as originally null.

5.2.3 Voidable contract

A 'voidable contract' in China is a contract in which a contracting party's true intentions are not properly expressed. Therefore the law allows a contracting party to claim that the contract is void or modifiable.⁵²⁴ A contracting party whose intention is not properly expressed is able to choose whether or not to claim that the contract is void. Without a party's claim, or if the party gives up his right of claim, the contract still takes legal effect. In addition, the party can also claim to modify the contract instead of invalidating it. For example, where a seller made a misleading description about the value of his goods, the buyer can claim to modify the contract so that both contracting parties' obligations and rights are on the basis of fairness. Generally speaking, a contracting party is entitled to claim that the contract is void or modifiable under the following circumstances: (i) the contract is concluded by a contracting party's serious mistake; (ii) the contract is concluded on an obviously unfair basis; (iii) the contract is concluded by a party's fraud, duress or undue influence.⁵²⁵

The court will decide whether a contract ought to be invalidated or modified, and

⁵²³ Article 56 of the Chinese Contract Law says, "The contract which is confirmed invalid or discharged takes no legal effect *ab initio*. Where only a part of the contract is invalid and its invalidity does not affect rest parts of the contract, the rest parts are effectively independently."

⁵²⁴ Wang Liming & Cui Jianyuan, "New Study on the Chinese Contract Law", (2000) The Chinese Zhengfa University Press, p280

⁵²⁵ Article 54, The Chinese Contract Law 1999

before the court makes any decision the contract is still regarded as enforceable. Therefore, the obligor is not able to defend against the third party's claim by reason that the contract is voidable or modifiable before the court's decision is made. Where the third party claims to enforce the contract and at the same time the obligor claims to invalidate or modify the contract, the court can decide to stay the proceedings until the claim of voidable or modifiable has been decided. Under article 54, the contracting party's right of modification is not influenced by the 'crystallisation test'. That is, even if the third party's right is secured after satisfaction of the statutory crystallisation test or other tests which are expressed in the contract, the contracting parties are able to claim the right of modification. The obligor's defence is just based on the voidable contract.

Moreover, even if it is the obligee who claims for invalidating or modifying the contract under article 54, the obligor is also entitled to defend against the third party's claim on the basis that the contract has become invalid or been modified, or ask for a stay of proceedings before the court makes a decision on whether the contract shall be invalidated or modified.

5.2.4 Conditional contract

Where a certain condition is attached to the contract, the contract or part of contractual terms may become valid or become invalid relying on whether the condition is satisfied or not.⁵²⁶ Here, the condition is the only one which decides the validity of the contract. One situation is the contract with a positive condition attached - where the contract will become valid once the condition is satisfied. Another situation, on the contrary, is the contract with a negative condition attached by which the contract will become invalid once the condition is satisfied.⁵²⁷ Contracting parties

⁵²⁶ Wang Liming & Cui Jianyuan, *New Study on the Chinese Contract Law*, (2000) The Chinese Zhengfa University Press, p251

⁵²⁷ Article 45 of the Chinese Contract Law just provides the same rule.

are able to create a condition for the validity of the contract or part of the contractual provisions even if the contract is for the third party's benefit. In particular, the parties may set a condition as the premise of effectiveness of the provision which the third party's enforceable right derives from. If a positive condition is set, the third party's claim is subject to the obligor's defence based on the reason that the condition is not satisfied so the provision concerning his right takes no legal effect. If a negative condition is set, the third party's claim is subject to the defence that the condition has been satisfied so that the provision concerning his right becomes invalid.

It is universally recognised that existence of a valid contract is the premise of the third party's right. Since the right is created by a contract between an obligor and an obligee, where there is no contract, there is no right. The obligor has a valid defence against the third party beneficiary if the contract takes no legal effect. The reasons leading to invalidity of the contract are normally provided by the law such as lack of consideration, lack of capacity, failure to comply with form requirements or violation of public policy.⁵²⁸ Reasons could also be agreed by the parties such as establishment of a condition for validity of the contract.

The German Civil Code article 334, providing that defences arising out of the contract are available to the obligor against the third person as well, obviously includes the defence based on an invalid contract. English Law has the similar provision, under section 3(2) (a) of the 1999 Act, defences arising from or in connection with the contract are available to a promisor in an action brought by the third party. Therefore, those matters which affect the existence, validity and enforceability of the whole contract or of the particular provision benefiting the third party are reasons for the promisor's defences.⁵²⁹ In Scotland, the principle is that if

⁵²⁸ Germany: Staudinger (-Kaduk) § 334 no.21-24; Larenz 223 ss.; Esser and Schmidt 594. France: Planiol and Ripert (-Esmein) no. 363; Legier no. 191 ss.; Ripert and Boulanger no.674; Beudant and Lerebours- Pigeonniere (-Lagarde and Penot) no. 957; Cass req.19 Dec. 1892, S 1895.1.225 note Tissier. International Encyclopaedia of Comparative Law – Third Party Beneficiaries, p47

⁵²⁹ Law Commission No 242, par.10.2, 115

there is a defect in the contract's formation rendering it invalid or potentially null (void or voidable), then the third party's right is equally invalid or potentially null. Where the original contract is illegal, the right conclusion may be less clear if only part of the contract is illegal and that does not include the conferment of the third party right. But if the third party right is dependant upon the illegality, then it seems that it is unenforceable.⁵³⁰ And the Second Restatement of Contract in the United States also provides that a contract which is voidable or unenforceable at the time of its formation can create no superior right in a third party, and that where a contract ceases to be binding in whole or in part because of impracticability, public policy, non-occurrence of a condition, or present or prospective failure of performance, the right of any beneficiary is to that extent discharged or modified.⁵³¹

5.3 Defences based on the obligee's action or inaction

Where an obligee brings an action, the obligor may defend by reason of the obligee's action or inaction in performing his counter-promise. For example, an obligee fails to complete all his contractual obligations, or delays his performance. If a third party beneficiary brings an action on the contract, could the defences based on the above reason still be available to the obligor?

5.3.1 Invalidity of rescission of the contract as a result of the obligee's action or inaction

First of all, as discussed above, if an obligee's action or inaction directly leads to the contract becoming invalid or unenforceable, the obligor therefore has effective defences. For example, where the contract is made under the obligee's actions such as

⁵³⁰ Hector L MacQueen, *Contract Law in Scotland*, (2000) Butterworths (Scotland), pp80-81

⁵³¹ Second Restatement of Contracts, § 309

fraud, duress or undue influence, or under the obligee's inactions, say, the obligee failed to notify the obligor some important facts which are relevant to their transactions, then the obligor is entitled to claim that the contract takes no legal effect so he no longer owes obligation to carry out the promise for the benefit of the third party.

Secondly, the obligor may claim to cancel the contract in the following circumstances under the Chinese Contract Law article 94: (i) the obligor's purpose to enter into the contract is frustrated because of force majeure; (ii) before the date of performance, the obligee refuses to perform his fundamental contractual obligation expressly or by conduct; (iii) the obligee delays in performing his fundamental contractual obligation, and after the obligor's request he still fails to complete performance in a reasonable period; (iv) the obligee delays in performance of the contract or fails to perform other obligations so that the obligor can no longer realize his purpose in entering into the contract; (v) other particular conditions provided by the law. Since any one of the above factors affects the validity of the contract, defences available to the obligor against the third party's claim could be on the basis that the contract has been rescinded or is to be rescinded. That is, if the obligor's claim to rescind the contract is approved by the court, the obligor's defence is that he owes no obligation to the third party. While if the contract is awaiting to be cancelled, the obligor can request for stay of proceedings of the third party's claim until the result of the claim.

Similar solution has ever been used by the *Cour de cassation* in a French case where a buyer in a contract for the sale of a going business had promised the seller to purchase a certain quantity of grain from C at the agreed price. When C, tendering the grain, sued the buyer for the price, the buyer asked the court to stay the proceedings until a lawsuit, brought by him against the seller of the business for rescission of the contract because of a breach by the seller, had been decided. The *Cour de cassation* held that the lower court was right in staying the proceedings since the agreement for

the benefit of C “constituted an agreement for the benefit of a third party whose validity was subordinated to that of the sales agreement on which it was based.”⁵³²

5.3.2 Defences based on the obligee’s non-performance or unsatisfactory performance

If an obligee’s breaks his own contractual liabilities, could the obligor use it as the reason to defend in the third party beneficiary’s action? In order to answer the question, it is necessary to make clear the relation between an obligor’s obligation to a third party beneficiary and the obligee’s counter-promises to the obligor. In theory, the obligor makes promises for the obligee’s counter-promises in return. Under the Chinese contract laws one party’s contractual rights are just another party’s contractual obligations, and vice versa. The law aims to protect both parties’ expectations equitably. Failure to carry out the promise satisfactorily by either one of them would cause frustration of the other one’s expectation for entering into the contract. In this regard, an obligee’s non-performance or unsatisfactory performance could be the reason for the obligor to defend in the third party beneficiary’s action.⁵³³ This point will be further discussed from the following four situations.

1. In a bilateral contract, if there is no order of the parties’ performance, both parties shall carry out their liabilities at the same time, and one contracting party is entitled to refuse another party’s request for his performance before the latter’s corresponding performance.⁵³⁴ Such a defence directly arises from

⁵³² Cass. Com. 25 March 1969, Bull.civ. 1969 IV 117 no. 118; International Encyclopaedia of Comparative Law –Rights of Third Parties, p48

⁵³³ See Wang Liming & Cui Jianyuan, “New Study on the Chinese Contract Law”, (2000) The Chinese Zhengfa University Press, pp337-338; Ma Qiang, “Simultaneous Defences of Performance”, (2001) 2, Legal Forum (Faxue Luntan), 77

⁵³⁴ The Chinese Contract Law, article 66

the nature of a bilateral contract.⁵³⁵ That is, in a bilateral contract, the relation between a party's rights and another party's obligations is causal and they depend on each other. The parties' contractual rights and obligations are mutual conditions for each other's existence. Non-existence or invalidity of a party's contractual right causes the same result to another party's contractual right. This theory is also applied in a contract for the benefit of third parties. Therefore, if A and B promised to confer a benefit on C, without B's counter performance, A is able to refuse to perform his promise to C.

2. Where there is an order of performance provided in a bilateral contract, the party who owes an earlier obligation shall complete his performance first. Otherwise another party has the right to refuse his own performance. In addition if the party who owes an earlier obligation does not perform properly or satisfactorily as required in the contract, another party can also refuse to perform his corresponding obligation.⁵³⁶ In this regard, in the contract for the benefit of C between A and B, A ought to perform his obligation first to B before B performs to C as agreed in the contract. If A fails to carry out his promise or his performance does not measure up to the contract, this could be the reason for B to defend against C's claim. However, if part of the obligee's performance is completed satisfactorily, the defence available to the obligor is only on that unsatisfactory part of performance. For example, A and B entered into a contract and B promised A to supply him two tons of pearl millet, half in spring and half in autumn. In return, A promised B to pay him half of the contract price for Spring pearl millet and another half payment for Autumn pearl millet to C. A subsequently supplied one ton of spring goods but only half a ton of Autumn goods due to reduction of output. Then B has the right to

⁵³⁵ See Cui Jianyuan & Yang Minggang, "Interpretation of A Contract", (1996) 12, Legal Science (Faxue); Wang Liming, "Several Difficult Issues in Constituting the New Chinese Contract Law", (1997) 2, The Journal of The Zhengfa University

⁵³⁶ Article 67, the Chinese Contract Law 1999

refuse full payment of half of the contract price to C, as agreed in the contract. But he cannot refuse to pay the corresponding price of the goods which B had supplied. In addition, B cannot refuse to pay C by reason that the spring goods provided by A are defective.

3. The contracting party who owes an earlier contractual obligation has the right to stop his performance under any one of the following circumstances: (i) another party's financial status becomes seriously deteriorated; (ii) another party transfers or extracts money in order to avoid his debt *mala fide*; (iii) another party has lost his credit standing; (iv) another party falls within other situations which can prove that he has lost capability to perform the contract.⁵³⁷ Such a right is also available to the obligor as reasons of defence against the third party beneficiary's right. The defence will be supported by the court as long as the obligor is able to prove the existence of one of the above situations. Otherwise the third party's claim will be supported and the obligor must take liabilities for breach of contract.

4. Where the obligee states by words or by conduct that he will not carry out his contractual liability, the obligor also has the right to stop performance of his own contractual liabilities. Such a right shall extend to a third party's action so that the obligor defends against the third party's claim by reason of the obligor representing his intention to reject performance. It was held that the Chinese contract law follows the rule of "anticipatory breach" in Common Law system in practice even before this rule was adopted in the Chinese Contract Law 1999⁵³⁸ so that the obligor is actually not only able to refuse to perform his contractual liabilities and claim for compensation, but also has

⁵³⁷ Article 68, the Chinese Contract Law

⁵³⁸ Article 108, the Chinese Contract Law

the right to rescind the contract.⁵³⁹ This rule should also be applied in the third party's claim. Therefore the obligor could defend by reason of the obligor's actions or by reason of an invalid contract if the obligor's request to rescind the contract is approved by the court.

A lot of countries' laws also recognize that the obligee's failure to perform a counter-promise made to the obligor is a valid defence available to the obligor in the third party's action.⁵⁴⁰ In Scotland, it is held that the debtor's obligations to the third party is unaffected by the stipulator's breach in principle, but in practice the stipulator's breach may make it impossible for the debtor to perform, or the debtor's obligations may be contingent upon the performance which the stipulator is to render under the contract.⁵⁴¹

5.3.3 Insurance contracts

The problem frequently arises from insurance contracts about the insurer's defences

⁵³⁹ *Zhang Shi Cotton Provider v Chang Liu mill factory* was decided based on the theory of "anticipatory breach" in 1995. The plaintiff enters into a contract with the defendant and agreed that the defendant supplied 1,000 dans to the plaintiff in Nov 1994. In September, the agent of the defendant informed by telephone the plaintiff that they could not carry out the promise because output of cotton was reduced by waterlog. However, the plaintiff proved subsequently that what the defendant said was not the truth. The fact was the defendant had entered into another contract of sale for obtaining a higher price. After negotiation, the defendant still refused to perform the contract. Then the plaintiff brought an action against him for specific performance. The court decided that although November was the defendant's true date of performance, his action led to the same result as if he refused to perform in Nov. Therefore, in order to protect the plaintiff's rightful benefits the law should allow him to ask for specific performance, compensation and rescission of the contract. Also the commentator expressed the same opinion and referred to the English case *Ochster v De La Teur* 118 Eng Rep. 922. Q.B. (1853)

⁵⁴⁰ International Encyclopaedia of Comparative Law – Third Party Beneficiaries, p48; Germany: Staudinger (-Kaduk) § 334 no. 27-30; Gernhuber 494 ss.; RG 27 April 1907, RGZ 66, 97; RG 27 April 1915, JW 1915, 652. France: Ripert and Boulanger no. 674; Legier no. 201 ss.; Beudant and Lerebours-Pigeonniere (-Lagarde and Penot) no.957; Planiol and Ripert (-Esmein) no.363. United States: Corbin IV § 819; Williston (-Jaeger)II § 395.

⁵⁴¹ The Laws of Scotland Stair Memorial Encyclopaedia Vol 15, par. 839, 544

against the beneficiary's claim based on the insured's action or inaction.

First, the insurer may plead defences based on the failure of the insured to pay the premium. For example, Company A enters into a contract with Insurance Company B to buy health insurance and individual accident insurance for its employees. Where A fails to pay the premium, or pays premium less than the agreed amount, or fails to pay on time, B has the right to defend against the employees' claim for the insurance. Secondly, the insured owes a liability in the insurance contract to disclose all the important information related to the insurance. Such a liability is regarded as the insured's basic contractual obligations, required by the principle of honesty and trustworthiness in China. Failure to perform such liabilities leads to the insurer's rejection to pay insurance to the insured or the third party beneficiary. In addition, the insurer also has the right to request cancelling the contract if he can prove that the insured disguised important facts deliberately or negligently when the contract was made.⁵⁴² Thirdly, in the contract of property insurance, defences available to the insurer are based on the fact that occurrence or enlargement of the insurance event is caused by the insured's fault. The insured owes a liability to take reasonable steps to avoid occurrence or enlargement of the loss.⁵⁴³ Failure to do so gives the insurer defences against the third party beneficiary's claim. Fourthly, if the

⁵⁴² Article 17 of the Chinese Insurance Law provides "The insurer shall, prior to the conclusion of an insurance contract, explain the contract terms and conditions to the applicant and may inquire about the subject matter of the insurance or person to be insured. The applicant shall make a full and accurate disclosure. The insurer shall have the right to terminate the insurance contract, in the case that the applicant intentionally conceals facts, or does not perform his/her obligation of making a full and accurate disclosure, or negligently fails to perform such obligation to the extent that it would materially affect the insurer's decision whether or not to underwrite the insurance or whether or not to increase the premium rate. If any applicant intentionally fails to perform his/her obligation of making a full and accurate disclosure, the insurer shall bear no obligation for making any indemnity or payment of the insurance benefits, or for returning the premiums paid for the occurrence of the insured event which occurred prior to the termination of the contract. If an applicant negligently fails to perform his/her obligation of making a full and accurate disclosure and this materially affects the occurrence of an insured event before the termination of the contract, the insurer shall bear no obligation for making any indemnity or payment of the insurance benefits but may return the premiums paid. An insured event refers to an event falling within the scope of cover under the insurance contract."

⁵⁴³ Article 42 of the Chinese Insurance Law.

insured waives the right of indemnity against the third person after the occurrence of the insured event and before the insurer making the indemnity, the insurer bears no obligation to indemnify the beneficiary. Moreover, the insurer may deduct a corresponding sum from the amount of indemnity if it is not able to exercise the right of indemnity by subrogation due to the fault of the insured.⁵⁴⁴ Fifthly, in a contract of liability insurance, if the person who is injured in an automobile accident brings an action against the insurer, defences available to the insured against the plaintiff are to the extent as if the action was brought by the insured. It is held that unreasonable inconsistency was caused if the third person could get more indemnity by suing the insurer than suing the insured.⁵⁴⁵ But since the contract of liability insurance is made for effective compulsory indemnity liability taken by the insurer to the third person, the exemption or limitation clauses provided in the contract would not be available to the insurer to defend against the third person.⁵⁴⁶

The contracting parties may make a different agreement on availability and scope of the insurer's defences against the third party beneficiary. For example, a fire insurance contract may provide that the loss shall be payable to the mortgagee and that his right shall not be invalidated by negligent conduct of the owner. The problem is whether and how far the contractual provisions deprive the insurer of defences that would be valid were he sued by the insured.⁵⁴⁷ In principle, the contracting parties have the right to make an agreement to exclude the insurer's defences against the third party beneficiary; therefore whether the obligor can defend against the beneficiary's claim, and how far he can do so depends on the parties' intention. On the contrary, the contracting parties may make an agreement that the third party's claim is subject to all the defences that the insurer would have had against the insured. For example, a head-contractor enters into an insurance contract to cover itself and all subcontractors

⁵⁴⁴ Article 46 of the Chinese Insurance Law.

⁵⁴⁵ <http://jjsfy.chinacourt.org/public/detail.php?id=56> 21 April 2006

⁵⁴⁶ <http://jjsfy.chinacourt.org/public/detail.php?id=56> 21 April 2006

⁵⁴⁷ The problem was brought forward in International Encyclopaedia of Comparative Law – Third Party Beneficiaries, p49

working on the project. If the contract provides that the insurer could have all defences against the subcontractor's claim as if the claim was made by the head-contractor, the subcontractor's claim might be defeated on the ground of the head-contractor's actions or inactions, say failure to pay premium or non-disclosure by the head-contractor, no matter whether these reasons are known or unknown to the subcontractor. This is because the third party's right originates from the contracting parties' intention and his right is also limited if it is the parties' intention.

The same opinion was expressed in the Law Commission Report. Under the Law commissioners' point of view, the only requirement is that the contract contains an express provision:⁵⁴⁸

The contracting parties may include an express provision to the effect that the obligor may not raise any defence or set-off that would have been available against the obligee; conversely, the parties may include an *express* provision to the effect that the third party's claim is subject to all defences and set-offs that the obligor would have against the obligee.

5.3.4 Contracts involving multiple transactions

The defences are available to the obligor against all third party beneficiaries covered in the contract, even the third party was not fixed or does not exist when the contract is made. For example, in a construction contract, where the contractor and the employer make an agreement that the benefits of repair free of charge for ten years are extended to the subsequent owners or occupiers, the subsequent owner's claim to repair the premise may meet the contractor's defences by reason that the employer fails to perform his counter-promise satisfactorily: for example, the employer has an outstanding payment or the employer provided a faulty design plan. For another

⁵⁴⁸ The Law Commission No 242, par. 10.15, p121

example, the employer B sold the property to C, and later C rent the premise to D. D found cracks in the building so he decided to ask the contractor A to repair it. According to the contract between A and B, the occupier D should have had the right to request it. In this case, the defences on the ground of the employer's non-performance or unsatisfactory performance are available to the contractor against D's claim, although the reasons for these defences are unknown to D. In addition, the contractor can also defend against D by reason of the employer's fault, say, cracks in the building were caused by the employer's improper decoration or design.

Similarly, Company B which was in financial crisis entered into a contract with appraiser A before selling its business to C. Based on the appraisal, C bought B's business. Later C resold the business to D. D found that the appraisal was far away from its real value. In the action brought by D, A may defend by reason of, for example, B's misstatement, B's false information or misleading document.

As discussed above, the contracting parties may exclude the promisor's defences based on the obligee's non-performance, unsatisfactory performance or other actions or inactions against the beneficiaries covered in the contract by express words. Such contractual provisions are recognized by the law. In a German case,⁵⁴⁹ the defendant, an airline company, chartered seats to company T. for a return flight from Frankfurt to Santa Lucia. Company T, passed on a number of these seats to company O, Fernreisen GmbH, a travel agent, for air package tours. Later company T. stopped payments. On the date of return flight, the employees of the defendant refused to let a Mrs. H. take the return flight to Frankfurt, although she had booked with company O. The court of appeal (Berufungsgericht) was of the opinion that the charter contract between company T. and the defendant constituted a true contract in favor of a third party as set out in para.328 BGB, by which Mrs. H. had obtained against the defendant a right to

⁵⁴⁹ BGHZ 93, 271 VII. Civil Senate (VII ZR 63/84), *Charterflug*-decision = NJW 1985, 1457, http://www.ucl.ac.uk/laws/global_law/german-cases/cases_bundes.shtml?17jan1985 25 Feb 2004

transport. It was held that the airline company could not defend against the plaintiff's claim by reason that Company T had not fulfilled the contract. Article 334 of the German Civil Code which provides that the promisor can use pleas arising from the main contract against demands from the third party could not be applied in this case because the very nature of the main contract meant that the debtor could not use all pleas from this contract against the third party.⁵⁵⁰ Compared to the recommendation of English Law Commission Report, the exclusion of the promisor's defences could be assumed by examining the nature of the contract, but not limited to the contract language only.

5.4 Defences based on the third party's action or inaction

The question to be discussed in this part is whether an obligor could have a valid defence based on the third party beneficiary's actions or inactions. On one hand, the third party's action or inactions may affect the validity of the contractual provisions from which his right originates. On the other hand, the third party's actions or inactions may affect or change the relationship between him and the obligee, or the relationship between him and the obligor so that such a change gives a reason for the obligor to defend against the third party's claim.

⁵⁵⁰ The defendant concluded the charter contract with company T. - a tour operator - which then transferred the chartered airline seats to company O. - against a tour operator. For this reason the defendant had to assume that the seats were used as part of travel contracts concluded by the tour operators with travellers and that these travellers would already have paid the costs of the flight, included in the overall price for the journey, before the start of the journey irrespective of whether or not they had been obliged to do so. The defendant had also agreed that company T. issued air tickets for the seats which he had chartered out. Under these circumstances the defendant must have known - as the appeal court rightly assumes - that passengers booking an air package tour and who are not aware of the specific legal form of the transport contract, expected and could expect that their claim for transportation against the defendant was free from pleas. As chartered party, the defendant could not oppose Mrs. H.'s claim by pleading that the charter contract had not been fulfilled. Rather, it is part of his area of risks to ensure that payments which passengers made for the flight are received by him in time. http://www.ucl.ac.uk/laws/global_law/german-cases/cases_bundes.shtml?17jan1985 25 Feb 2004

5.4.1 Invalidity of the contract caused by the third party's action or inaction

If contracting parties enter into a contract under the third party's fraud, duress or undue influence so that the contract actually does not embody the parties' true intentions, the obligor has the right to reject contractual liabilities and defends against the third party's claim. In such a case, the defences against the third party beneficiary's claim is that the contract or the contractual provisions concerning the third party's right are invalid so that the third party does not have an enforceable right. The fact of the third party's fraud, duress or undue influence constitutes the reasons for the obligor or the obligee to claim invalidity of the contract. Once the contract is treated as invalid by the court, it means the third party does not have any enforceable right. For example, a woman gets cancer but knows nothing about it. Her husband who is aware of her sickness advises his wife to buy a life policy. The wife buys the policy and the beneficiary is her husband. After the wife dies, the insurer finds out that the husband knew about his wife's sickness before the insurance contract was made. The insurer has the right to claim that the contract is invalid because of the beneficiary's fraud and non-disclosure.

5.4.2 The third party's cooperation required by the principle of honesty and trustworthiness

According to the principle of honesty and trustworthiness, contracting parties hold liabilities of assistance, co-operation and keeping business secrets.⁵⁵¹ This means that

⁵⁵¹ Article 60 of the Chinese Contract Law provides, "both contracting parties shall perform their own contractual liabilities properly and fully. In line with the principle of honesty and trustworthiness, the third party shall hold the liabilities of information, assistance and keeping secret according to the nature of the contract, aim of transaction and commercial custom."

the obligee and the obligor are liable to assist the each other's performance and keep business secrets for each other if trade custom requires. Similarly, third party beneficiaries shall take the responsibility for convenience and co-operation to receive the performance from the obligor. Otherwise, the obligor has the right to defend against the beneficiary's claim or ask for set-off. For example, if B promised A to deliver the goods to C, C is required to assist, say to collect the goods at an appointed place in time. Similarly, if B promised A to pay the contract price to C, C is required to provide his bank account information so that B is able to transfer promised money on time. Company A enters into an insurance contract with Company B to cover property for itself and the subsidiary Company C. Where C's offices were burned in a fire, C is required to give necessary information for B's investigation. For another example, where B promised to deliver the goods to C on a certain date, but C did not collect it until one week later, if C brought an action against B for the defective goods, B has a set-off against C's claim on the ground that C's delay of collection caused extra storage charge to B.

The general rule is that the third party holds no liability in a contract. Under this rule the third party beneficiary's failure to give co-operation or assistance does not give the obligor reasons to sue the beneficiary. It only enables the obligor to defend against the beneficiary's claim, or ask for set-off.

In addition, the third party is liable to take reasonable steps to avoid loss enlargement. If he fails to do so, he cannot claim damages for the extra loss caused by his inaction.⁵⁵² A typical case is that a third party beneficiary in an insurance contract is required to take reasonable actions to avoid loss enlargement when the insured event occurs. If the beneficiary fails to do so, the insurer has the right to refuse payment of the extra loss suffered by the beneficiary or ask for set-off.

⁵⁵² Article 119, the Chinese Contract Law 1999

5.4.3 Negative prescription rule applied in the third party's claim

A general rule in the Chinese Civil Law – except for specific rules provided in particular laws, the claim shall be raised within two years from the time that the plaintiff knows his right has been infringed or from the time that he should know his right has been infringed.⁵⁵³ Under the Chinese Contract Law, it is provided that negative prescription of international contracts for sale of goods and contracts for technology of import and export is four years. Specific rules in other laws and regulations shall be applied to particular contracts accordingly.⁵⁵⁴ In addition, there is a rule especially on the claim for non-pecuniary performance provided in the Contract Law – if an obligor fails to perform his non-pecuniary contractual liability, or his non-pecuniary performance is not satisfactory, the obligee is entitled to ask for specific performance, unless the obligee does not make a claim within a reasonable time.⁵⁵⁵ All these rules of prescription as restraints on the obligee's claim shall be available to the obligor in the third party beneficiary's claim.

5.4.4 Pre-condition of the third party's claim

According to the principle in Chinese contract law, contracting parties have no right to impose any obligation on a third party who is not a party to the contract. However, the parties may create conditions for the third party to obtain the benefit, create conditions for securing his right or create the possibility for the obligor to stop performance to the third party. The English Law Commission makes a further discussion on a distinction between imposing a burden on the third party and conferring a conditional benefit upon him:⁵⁵⁶

⁵⁵³ Article 153, the Chinese Civil Law 1986

⁵⁵⁴ Article 129, the Chinese Contract Law 1999

⁵⁵⁵ Article 110, the Chinese Contract Law 1999

⁵⁵⁶ Law Commission No 242, par. 10.32, 127

The distinction is an easy one to draw where the condition does not require performance by the third party... (However) drawing the distinction is, perhaps, more difficult where the condition requires performance by the third party... The distinction between imposing burdens and conditional benefits (and hence the line between what falls outside our reform and what falls within it) depends on whether the condition is the basis merely of a defence or set-off to the third party's claim or whether, on the contrary, the condition is the basis of a claim or counter-claim by the obligor against the third party.

On the one hand, contracting parties have the right to create a condition for the effectiveness of contracts or some of contractual provisions from which third parties' enforceable rights derive. If the condition is a provision for occurrence of an event or end of an event, there is no doubt that these conditions are rightful and defences are available to the obligor if the conditions are not satisfied. For example, the condition must be about reaching a certain age. A man promises his sister to give one of his houses to the nephew when the nephew attains majority. Before the nephew attains majority, the obligor is not liable to carry out his promise. If the condition concerns requesting a performance from the third party, the third party can freely choose to carry out the performance or not. If the third party refuses to the performance, the obligor cannot enforce it but he can defend against the third party's claim.

On the other hand, if the condition is not satisfied, it does not affect the validity of the contractual provisions but gives reasons for the obligor to reject carrying out his own promise. The condition must be expressly provided in the contract so that the third party beneficiary can know about it. For example, company A promises a college B to sponsor a series of research programs so that all the researchers who join in the programs will get the benefit from the fund. The condition is that the fund must be used for the research programs only. Those researchers who retreat from the programs or use funds for other purposes will not get the benefits any longer. Based on this provision, company A has the right to stop providing fund if the beneficiaries fail to satisfy the condition. On the other hand, without express contract terms, such a

defence is not available to A.

For another example, A promises B to deliver goods to C. Unless the condition that C has to pay for the delivery fees is agreed in the contract, A can neither request it before dispatching the goods nor defend against C's claim by reason of C's failure to pay the delivery fees. In the *Dayang Engineering Plastics Corporation v. Junyou Industrial Chemicals Factory*⁵⁵⁷ the plaintiff entered into a contract for sale with the defendant, and the defendant promised to deliver the goods to the third party Kaiwang Company. However in this case it was the buyer who brought the action against the seller for damages due to the defective goods. The third party, Kaiwang Company was not involved in the case because he refused the request from the defendant for payment of delivery fee and refused to accept the goods. The commentator explained the application of the conditional contractual terms:⁵⁵⁸

Our general rule decides that contracting parties have no right to impose any burden on a third party, and the contract term would deem to be invalid if they do so. However, the fact in this case is different with the normal situation where contracting parties impose a burden on a third party because requiring the third party to fulfill the obligation is just the condition of performance of the obligor's contractual obligation. In addition, the most important thing was that such an obligation has no binding effect on the third party. This means Kaiwang can choose to accept it or not freely. If Kaiwang had accepted the condition expressly or by conduct, it meant that Kaiwang wished to take the responsibility of his own and therefore it could be seen as if a new agreement was created between Kaiwang and Junyou. Under this situation, Junyou was entitled to refuse to perform his contractual liability to Kaiwang or defend against Kaiwang's claim if Kaiwang fails to satisfy the condition.

It is correct that the third party can accept or reject the obligation, but the opinion that a new agreement comes into existence once the third party accepts the condition

⁵⁵⁷ Selected Civil Cases of the Chinese Courts II, People's Court Press, 254

⁵⁵⁸ Ibid. 262-267

expressly or by conduct may not be reasonable. This is because, based on this opinion, if a new agreement is created between a third party and an obligor, this means that the obligations agreed in it are enforceable by the obligor and he has the right to sue the third party if the third party fails to fulfill the obligation. This is contradictory to the general rule that no enforceable obligation should be imposed on a third party.

5.5 Defences based on exemption clauses

In a normal two-party contract, exemption clauses are available to an obligor against obligees' claim. One type of ground for exemption arises from the statutory provisions and therefore defences are available to the obligor when the legal requirements are satisfied. Another type of ground for exemption derives from the agreement between the obligor and the obligee themselves. The question is whether the above defences are also available to the obligor against a third party's claim.

The problem of the doctrine of liability fixation is interesting and debatable in the Chinese academic sphere for a long time.⁵⁵⁹ It is accepted that the 1999 Chinese Contract Law mainly adopts a strict liability principle – an obligor is answerable for his breach of contract, regardless whether he has been at fault in fact.⁵⁶⁰ First, in a

⁵⁵⁹ Some scholars argued that the Chinese Contract Law must introduce the principle that a obligor is liable for breach of contract only under the circumstance that he cannot prove that he has no fault, which is prevalently established in the civil law countries. See Xie Bangyu, *Civil Liability*, (1991) Law Press, p107; Wang Jiafu, *Contract Law*, (1986) The Chinese Social Science Press, p481. Some other scholars proposed that the a strict principle coming from common law that if an obligor fails to do what he promised, he is liable in damages for breach of contract, regardless of whether he himself has been at fault or not. See Jin Xiao, "Fault – Not An Inseparable of Breach of Contract", (1987) 3, *Legal Science*. This third opinion is that which principle should be used to determine the obligor's liability for breach of contract depends on the nature of actions of breach and remedial measures, therefore the best way is to apply different principles according to the different liabilities for breach of contract. See Cui Jianyuan, *Liabilities for Breach of Contract*, (1992) The University of Ji Lin Press, p73; Wang Liming & Cui Jianyuan, *Study on Contract*, (1997) The Chinese Zhengfa University Press, p54.

⁵⁶⁰ Yang Lixin, "Execution and Application of The Chinese 1999 Contract Law", (1999) Ji Lin Remin Press, pp266-267; Wang Liming, "Impossibility of Performance of the Contract",

normal breach of contract case, where the promisee claims for remedial protection such as specific performance, remedial measures⁵⁶¹ compensation⁵⁶² and liquidated damages or deposit, the doctrine of strict liability must be applied. That is, as long as the obligor fails to perform or fails to properly perform his promise in the contract, he should face liability for breach of contract, no matter whether he is at fault or not. Secondly, the principle of liability for wrongs should also be applied to the liability for anticipatory breach. According to article 108 of the Chinese Contract Law, where a obligor shows expressly or by conduct that he will not perform his contractual liabilities, another party is able to claim for his liability for breach of contract before the date of performance. From the words “shows expressly or by conduct”, it is easy to judge that requirement of law to let the obligor to take the responsibility for anticipatory breach is that the obligor is at fault subjectively – intending to break his promise.⁵⁶³

5.5.1 Statutory grounds for exemption

The only statutory ground for exemption in the Chinese Contract Law is force majeure. Force majeure means the facts that are unpredictable, unavoidable and

<http://www.civillaw.com.cn/lawfore/CONTENT.ASP?programid=1&id=461> 9 Sep 2003. The strict principle is adopted in the new Chinese Contract Law 1999, whereas in the old Chinese contract laws, the doctrine of liability for wrongs was applied. Article 29 of the Chinese Economic Contract Law provided that where a contracting party failed to perform the required contractual liabilities due to his fault, he has to take the liability for breach of contract.

⁵⁶¹ Here the remedial measures especially mean some steps of help urgently to take in order to diminish the innocent party's loss, such as repairing, replacing, reworking, returning and reducing price.

⁵⁶² However, there are some exceptions to determine the promisee's liability for breach of contract based on the principle of liability for wrongs. For example, article 113 (par. 2) provides that the merchant supplies the products to the end-user by fraud, they shall take the liability of compensation according to the Chinese Consumer Protection Law. In such a case, the merchant's liability of compensation is only based on he is at fault.

⁵⁶³ Yang Lixin, “Liabilities Arising From the Contract”,

<http://www.civillaw.com.cn/lawfore/CONTENT.ASP?programid=1&id=141> 7 Sep 2003

uncontrollable and have a great impact upon performance of the contract.⁵⁶⁴ Generally speaking, the facts of force majeure, as interpretation in the Chinese Contract Law,⁵⁶⁵ include natural disaster, act of State and social unconventional events such as war or strike. Accidental events are not the grounds for exemption of an obligor's obligations, although in practice, accidental events are treated as grounds for exemption in very exceptional cases. Therefore if an obligor's failure to perform his contractual obligation causes a loss to the obligee due to the accidental events only, he still has to take the liabilities of damages or liquidated damages, even though he has not been at fault.⁵⁶⁶ For example, in a contract of service or employment, if the employer fails to perform the contract due to his serious illness, he is entitled to refuse to continue his performance before the obligee's action or after the action, but he still has to pay damages or liquidated damages.⁵⁶⁷

Force majeure is also available to an obligor to defend against a third party's claim. Accordingly the statutory provisions on the availability and limitation of force majeure are also applied to third party rights cases.⁵⁶⁸ It is generally provided in Civil

⁵⁶⁴ Article 117, Chinese Contract Law. This definition of force majeure is introduced from Force Majeure (Exemption) Clause of the International Chamber of Commerce – the party does not need to take a liability for breach of contract as long as he can prove (i) that the failure was due to an impediment beyond his control; (ii) that he could not reasonably be expected to have taken the impediment and its effects upon his ability to perform the contract into account at the time of the conclusion of the contract; (iii) that he could not reasonably have avoided or overcome it or at least its effects.

⁵⁶⁵ Liu Wenhua, *Interpretation on New Chinese Contract Law and Typical Cases*, (1999) The World Tushu Press, p122;

⁵⁶⁶ Therefore, compared to the theory of frustration in English law, the Chinese Contract Law takes an even stricter rule for the obligor's liability for breach of contract.

⁵⁶⁷ Wang Liming & Cui Jianyuan, *New Study on the Chinese Contract Law*, (2000) The Chinese Zhengfa University Press, p616; Also see Han Shiyuan, "Debatable Issues on Liabilities Arising from A Contract", *The People's Court Daily*, <http://www.civillaw.com.cn/lawfore/CONTENT.ASP?programid=1&id=292> 8 Sep 2003

⁵⁶⁸ Force Majeure is not only a valid reason for not taking the liability for breach of contract but also a valid to cancel the contract. According to the Chinese Contract Law (art. 94) the contracting party is entitled to rescind the contract where for majeure leads to that purpose of the contract cannot be realized. Therefore, the promisor is able to defence against the third party by reason of force majeure directly or by reason of invalidity of the contract. The same situation in some other countries. For

Law countries that the facts of force majeure are valid grounds for the obligor to be exempt his contractual liabilities.⁵⁶⁹ In Common Law countries the contracting parties can make an agreement about what uncontrollable and unavoidable events the obligor is able to be released from his contractual liability. In contrast, force majeure is the only statutory reason for exemption in China, and what kinds of events are involved in force majeure is only decided by the laws. In addition, it is noteworthy that even if the event involved in force majeure occurs during the performance of the contract, it does not necessarily lead to exemption of the obligor's whole liability.⁵⁷⁰ Whether an obligor's liability can be released in whole or in part depends on the particular facts of cases. For example, under some circumstances the events of force majeure only stop the performance temporarily, not permanently, and the obligor still has to complete the contractual obligations after the events. This rule is similar to the doctrine of "temporary impossibility" in American Second Restatement of Contracts.⁵⁷¹

5.5.2 Promissory grounds for exemption

As discussed above, contracting parties should be able to limit the value of the benefit to the third party by agreeing expressly that the third party's benefit is subject to defences that the obligor would have had against the obligee. If a contract includes exemption clauses or limitation clauses, the obligor shall have the right to enforce these clauses in a third party's action as if the action was brought by the obligee. Most of the countries' laws recognise that promissory exemption clauses shall be available

example, in England where a contract is discharged because of frustration, the promisor can also defence on the ground of invalid contract against the third party's claim. See Law Commission No 242, par. 10.2, 115

⁵⁶⁹ For example, German Civil Law § 275

⁵⁷⁰ The Chinese Contract Law (art. 117, par. 1) provides that where a promisor fails to perform his contractual obligation properly due to force majeure, his liability for breach of contract can be released in whole or in part correspondingly according to influence of force majeure. Where the fact of force majeure happens after the agreed date of performance, the promisor cannot depend on force majeure rule. The rules in other particular laws should be applied first if different.

⁵⁷¹ Restatement (2nd) Contracts, § 462

to the obligor to defend against the third party beneficiary.⁵⁷²

On the other hand, the exemption clauses or limitation clauses must be valid. The parties' agreement is subject to compulsory statutory provisions. For example, the exemption clauses will take no legal effect under the following two situations provided by article 53 of the Chinese Contract Law: (i) the exemption clause is invalid if it includes an agreement releasing one party's liability for another one's physical injury; (ii) the exemption clause is invalid if it includes an agreement releasing one party's liability for gross property loss suffered by another party due to his deliberate or gross negligence. These provisions shall also be applied where the obligor seeks to enforce an exemption clause or limitation clause in a third party beneficiary's claim.

In a contract of liability insurance, generally speaking if a person who is injured in an automobile accident brings an action against the insurer, defences available to the insured against the plaintiff are to the extent as if the action was brought by the insured. However, exemption clauses which release or reduce the insurer's liability for the third party's injury may take no legal effect under article 53 of the Chinese contract law. Moreover, it was held that the exemption or limitation clauses provided in the contract would not be available to the insurer to defend against the third person because by nature the contract of liability insurance was made for effective compulsory indemnity liability taken by the insurer to the third person.⁵⁷³ For example, where a contractual term provides that an insurer takes no liability for the third party's injury if the third party also has fault, the term takes no legal effect. For another example, a head-contractor takes out a policy to cover all personal injuries and accidental injuries caused during the construction work for itself and all the subcontractors. Such a provision is also invalid. Following the same logic, defences based on the exemption clauses are not available to the insurer if these

⁵⁷² International Encyclopaedia of Comparative Law – Third Party Beneficiaries, p48

⁵⁷³ <http://jjsfy.chinacourt.org/public/detail.php?id=56> 21 April 2006

clauses release or reduce the insurer's liability for the physical injuries: for example, a clause provides that the insurer will not pay for the insurance if personal injury is caused by the injured person's negligence.

But since the contract of liability insurance is made for effective compulsory indemnity liability taken by the insurer to the third person, the exemption or limitation clauses provided in the contract would not be available to the insurer to defend against the third person.⁵⁷⁴

5.5.3 Defences against the third party's claim for specific performance

Specific performance, according to the Chinese Contract Law theory, is one of the main remedial measures claimed by a contracting party where another contracting party fails to perform his contractual liability.⁵⁷⁵ The aim to claim for specific performance is to force the contract or to fulfill his liability according to the agreement in the contract so that the innocent party can realize his purpose to enter into the contract afresh.⁵⁷⁶ Generally speaking, a contracting party is free to choose to claim for specific performance alone or together with other remedial ways such as damages and liquidated damages.

However, regarding that specific performance has some special characteristics, the law creates some exceptions to apply such a remedy against the promisee. Since the very reason why specific performance is disallowed in particular situations is

⁵⁷⁴ <http://jjsfy.chinacourt.org/public/detail.php?id=56> 21 April 2006

⁵⁷⁵ Specific performance is regarded as one the most important remedial measures because it is efficient in realizing the party's purpose of entering into the contract. In addition, specific performance can be applied with other remedial measures (except rescission of the contract) at the same time, such as damages, liquidated damages and advance payment. See Wang Weiguo, "Specific Performance of A Contract", (1984) 3, Legal Studies

⁵⁷⁶ Liu Wenhua, Interpretation on New Chinese Contract Law and Typical Cases, (1999) The World Tushu Press, p113

decided on its nature and characteristics, instead of on something particularly related to the promisee, these exceptions are available as the obligor's defence against the third party's claim for specific performance. Article 110 of the Chinese Contract Law provides that:

Where a contracting party fails to perform his non-pecuniary obligation or his performance of non-pecuniary obligation is not satisfactory according to the contract, another party can ask him to continue to perform, unless: (i) the obligation cannot be performed at law or in fact; (ii) the nature of the subject matter of the contractual obligation decides the obligation is unsuitable to be performed⁵⁷⁷ or the performance fee would be too high; (iii) the obligee did not ask for the performance during a reasonable period.

Although not all restrictions created in the contract on the contracting party's remedies must automatically become restrictions on the third party's claim rigidly, I still think that article 110 must be applied to a third party's claim, that is, the third party's claim for specific performance is subject to the defence based on any reason mentioned above. This is because the reason explaining why the specific performance should be excluded under these circumstances is based on the fundamental purposes of contracts and the nature of the transaction, instead of based on any obligee's contractual rights or obligations.

5.6 Some specific issues

5.6.1 Relation between an obligee and a third party

⁵⁷⁷ Since some subject-matter of the contracts are personal services which are related to physical person's personality rights and freedom, these contracts are out of the scope of the contracts which can be claimed for specific performance. For example, to oblige an actor to perform or force a professor to give a lecture will vitiate their freedom and rights of personality.

In some cases the purpose of the obligee in conferring a benefit on the third party is fulfillment an obligation owed to the latter, for example, to pay off his debt to the third party created in another contract. The question is in these cases, whether the obligor has the right to refuse performance to the third party beneficiary if the creditor's right owed by the obligee to the beneficiary is terminated or becomes invalid. The answer is negative because a valid existing credit right of the obligee to the beneficiary is not the precondition for the obligor to perform his contractual obligations to the beneficiary. For instance, in a contract for sale, the seller requested the buyer to pay the contract price to a third person C so that he pays off his debt to C. Later C's creditor's right is barred by prescription. However, this does not release the buyer's contractual obligation owed to C. The rule is that any contract must be performed properly once it takes a legal effect. Each contract's legal effect is independent, and parties' contractual obligations are not affected by other contracts or transactions. This rule is also applied in contracts made for a third party's benefit, regardless of whether any change occurs between the beneficiary and the obligee. Following the same logic, in a contract for the benefit of a donee beneficiary, if the obligee becomes entitled to revoke the gift or has in effect revoked it, this does not protect the obligor against the donee beneficiary's claim.

However, contracting parties have the right to agree that a third party's valid right to the obligee is the precondition for the obligor to perform his contractual obligations. Or the contracting parties can make an agreement to discharge the third party's benefits if the third party loses a valid credit right to the obligee. In these situations, defences against the third party's claim are available to the obligor. However, in the latter situation, parties' exercise of modification or cancellation is subject to the "crystallisation test".⁵⁷⁸

It is universally recognised that a beneficiary's right against the obligor is not

⁵⁷⁸ Crystallisation tests are various in different countries. See discussion in chapter four.

subject to defences or claims of the promisee against the beneficiary unless the contract so provides.⁵⁷⁹ Under this general rule, in an obligee beneficiary case, if the debt owed by an obligee to the third party is barred by prescription or bankruptcy, or is later discovered by the promisee not to exist at all, this will not protect the obligor unless his promise to satisfy the third party was made conditional on the existence, validity or enforceability of the obligee's debt.⁵⁸⁰ Where the obligor fulfilled contractual obligations to a third party who does not have a valid credit right to the promisee, the obligee is able to claim for restitution of unjust enrichment.⁵⁸¹

5.6.2 Set-offs available to the obligor

The question is in what circumstances an obligor can request set-off in a third party's action. In a normal two-party contract, the obligor can set-off in the obligee's action on the ground that the obligee's actions or inactions are illegal or improper so that it leads to the obligor's loss or cause injustice to the obligor. The same rule could also be applied in a third party's action.

First, where an obligee's performance of his counter-obligation to the obligor is proved not satisfactory according to the requirements of the contract, the obligor can only carry out the corresponding part of his liabilities. If the obligee delays his performance, his performance is not qualified to the standard agreed in the contract or the promisee only fulfills part of his obligations, the obligor can refuse the corresponding performance or ask for a set-off in the promisee's claim. This could also be applied in the third party's claim because the reasons as the basis of set-off against the obligee's claim and the reason as the basis of set-off against the third party is the same – the nature of a contract decides that both parties enjoy their rights and

⁵⁷⁹ International Encyclopaedia of Comparative Law – Third Party Beneficiaries, p49

⁵⁸⁰ Corbin IV § 821-822; Staudinger (-Kaduk) § 334 no.11

⁵⁸¹ International Encyclopaedia of Comparative Law – Third Party Beneficiaries, p49; Corbin IV § 821-822; Staudinger (-Kaduk) § 334 no.9-10

perform their obligations equally and fairly, and both parties' proper implement of liabilities co-operatively could finally make the purpose of the contract realised.

Secondly, where a contract is or becomes voidable or dischargeable because of the obligee's improper actions or inactions, but the obligor cannot or does not want to rescind or invalidate the contract, then he is able to ask for compensation or ask for set-offs against the promisee's claim. For example, A promised B to pay the contract price to C for B's sets of machines in return. During the performance of the contract, A found that B excessively aggrandized functions of the machines. However A preferred not to rescind the contract but asked for reducing the price. Thus in C's action for A's promise, A may request set-off.

Thirdly, as mentioned above, the third party beneficiary's actions or inactions may give the obligor reasons to claim set-offs. This mainly happens in those contracts in which the obligations put on the third party as condition of obtaining the benefit, or obligations adhered to his benefit according to the statutes. For example the third party beneficiary covered by the fire insurance shall take reasonable steps to avoid enlargement of damage after fire occurs. Failure to do this may give the reasons for the obligor to claim set-off.

5.6.3 Counter-claim available to the obligor

According to the basic rule that a third party shall not take a burden as a result of obtaining the benefit in the contract, the counter-claim based on the original contract shall not be allowed in the third party's claim.

It seems difficult to distinguish set-off from a counter-claim if the basis of set-off and the reason as basis of counter-claim arising from the same transaction. Take the above case for example, the obligor asked for a set-off in the third party's claim for the contract price because his loss is caused directly from the promisee's

misrepresentation. The obligor's set-off which in order to diminish or extinguish the third party's claim, on the other hand, could also be seen as his claim to recover the expectation damages suffered by him. The principle is that the obligor's defences or set-offs lead to, at the most, that the third party takes no benefit from the contract, and it is absolutely prohibited that the third party must take any extra burden from his claim.

In English 1999 Act, section 3(4)(b) provides that a counterclaim is available to a promisor in a third party's action, but the matter of counterclaim must not arise from the contract. This rule is established based on the principle that reform of the third party rule is intended to enable the enforcement of benefits by third parties, not to impose burdens, and the third party's status must not become worse off as a result of his taking the benefit in the contract.⁵⁸² The Law Commissioners consider that this principle decides that counterclaims are available to the promisor only if the counterclaims do not arise from the contract.⁵⁸³

By contrast the New Zealand law allows the promisor's counterclaims without limiting the counterclaims arising from another contract but giving the following conditions: (i) The beneficiary shall not be liable on the counter-claim, unless the beneficiary elects, with full knowledge of the counter-claim, to proceed with his claim against the promisor; and (ii) If the beneficiary so elects to proceed, his liability on the counter-claim shall not in any event exceed the value of the benefit conferred on him by the promise.⁵⁸⁴

The American Restatement of Contracts 2nd § 309 (4) provides:⁵⁸⁵ "A beneficiary's right against the obligor is subject to any claim or defense arising from

⁵⁸² Law Commission No 242, par. 10.10, 119

⁵⁸³ Law Commission No 242, par. 10.18, 122

⁵⁸⁴ Section 9(4) of the New Zealand Contracts (Privity)

⁵⁸⁵ International Encyclopaedia of Comparative Law – Third Party Beneficiaries, p49

his own conduct...” However, the parties can make an express or implied term which provides that the obligor shall not be entitled to set off a counterclaim. Under this provision, if A asks his bank to pay his nephew a certain amount of money as a birthday present, it may well be the understanding of the parties that the bank shall not be allowed to refuse payment on the ground that the nephew owes money to the bank.

According to the Chinese contract law theory, the precondition of a counter-claim is that either party in the counter-claim holds the contractual liability to each other in the same contract.⁵⁸⁶ This rule makes the English solution which requires the obligor’s counterclaims arise only from different contracts unacceptable in Chinese Law. In addition, in my opinion, a better rule to be adopted in Chinese Law is that a third party beneficiary does not take any obligation in a contract, rather than adopting a principle that the third party may encounter counterclaims but his liability on the counter-claim shall not exceed the value of the benefit conferred on him by the promise. In order to avoid the possibility that a third party’s accepting the benefit in the contract leads to a contractual burden being imposed on him, the obligor’s counterclaims should not be allowed in Chinese law.⁵⁸⁷

5.7 Conclusion

Only a few countries’ statutes attempt to answer the question: what defences are available to the promisor against the third party’s claim.⁵⁸⁸ For example, the German Civil Code article 334 simply provides that “Defences arising out of the contract are

⁵⁸⁶ Article 120 of the Chinese Contract Law is the very basis for the contracting party to bring counterclaim. It provides that where both contracting parties fail to perform his contractual liability or their performance are unsatisfactory, they shall take the liability for breach of contract respectively.

⁵⁸⁷ In practice, for the sake of simplicity, the court may combine the two opposite claims in two cases for consideration altogether. But this does not normally happen because it requires that their claims do not include other people’s interests and their claims only concern pecuniary requests.

⁵⁸⁸ International Encyclopaedia of Comparative Law – Third Party Beneficiaries, p47

available to the promisor against the third person as well.” The Civil Codes of Austria (§ 882 par. 2), Greece (art. 414) and Japan (art. 539) follow the same way to resolve the problem as German Civil law does. The Italian Civil Code (art. 1413) and Portuguese Civil Code (art. 499) seem to give a little clearer explanation: “The promisor can raise against the third person defences based on the contract from which the third person derives his right, but not those based on other relationships between the promisor and the promisee.” Italian and Portuguese statutes emphasize that the defences should be only those arising from the contract that the third party obtains his enforceable right from.

In Common Law system, the recommendation of the English Consultation Paper provisionally provided that the right of the third party against the promisor should be subject to the promisor’s defences, set-offs and counter-claims which would have been available to the promisor in an action from the promisee.⁵⁸⁹ Section 3(2) of the Contracts Act 1999 provides that defences or set-offs are available to the promisor (i) if they arise from or in connection with the contract and are relevant to the term, and (ii) they would have been available to the promisor by way of defence or set-off if the proceedings had been brought by the promisee. The New Zealand Contracts (Privity) Act 1982, section 9(2) provides “The promisor shall have available to him, by way of defence, counterclaim, set-off, or otherwise, any matter which would have been available to him...(b) If (i) the beneficiary were the promisee; and (ii) the promise to which the proceedings relate had been made for the benefit of the promisee; and (iii) the proceedings had been brought by the promisee.

Referring to the above countries’ laws, the better solution could be that defences or set-offs available to a promisor are those as if the action was brought by a promisee. This normally includes reasons about the validity or enforceability of the contract, the promisee’s non-performance, or unsatisfactory performance. The provisions in the

⁵⁸⁹ Consultation Paper No 121 pars. 5.24 to 5.25, 6.10

law concerning availability for the promisor to defend against the promisee could also be applied to the third parties' actions. The parties have the right to agree on what specific defences are available to the promisor in the third party's action or what specific defences do not. In a contract conferring conditional benefit on a third party, the third party only gets right when the condition is satisfied, even if the condition puts an obligation on him. The third party beneficiary's failure to fulfill the obligation provided in the contract or in compulsory statutes gives sufficient reasons for the obligor to defend or set-off the beneficiary's claim.

CHAPTER 6

THE THIRD PARTY'S REMEDIES

6.1 Third party's right to contractual remedies

It is submitted that contractual remedies should be available to a third party beneficiary, after the third party acquired the enforceable right on the contract, including the right to claim for performance or damages from the promisor in his own name. Such a right is recognised by the law on the ground that where contracting parties allow a third party to sue, they should also have an intention to allow him to acquire all remedies provided in the contract law. Unless they expressly agree that the third parties may not have some certain remedies. Contractual remedies available to the third party means:

1. The third party has a right to sue based on the contract aiming to claim for recovery of his loss caused by breach of contract.
2. As his suit is based on contract, all remedies provided in the contract laws shall be applicable in his action.
3. The range of damages shall include all losses incurred to him, including loss of reliance interest and loss of expectation interest.
4. All restrictions on remedies stipulated in the law shall also be applied to

the third party's action.

Another important reason for the third party acquiring contractual remedies is experience from cases which indicate that the third party's loss caused by breach of contract should be recovered or can only be recovered by his own action; otherwise, injustice will be caused. For example, in *Tong Jin v Hailong Gas-fired Boiler Ltd*,⁵⁹⁰ the building owner employed Hailong Gas Boiler Ltd to install a central heating boiler. The contract provided that the quality of the boiler was guaranteed for five years and that Hailong Ltd should undertake the repair work unconditionally during this period. An assignment agreement made between the owner and the subsequent owner Tong Jin, when the building was sold to the latter, provided that the subsequent owner would have the right in the contract; however, the agreement took no legal effect because the owner did not inform Hailong Ltd about it. The owner, who had moved to another city, would not sue for Tong Jin's loss. The court upheld Tong Jin's claim for recovery of the repair expenses by reason that it would cause injustice to the plaintiff if he suffered loss as the result of Hailong's breach of its guarantee promises but could not recover it himself. In *Qin Shan Ltd. v Huaiyuan Electric Company and Futaixiang Ltd*,⁵⁹¹ Huaiyuan Electric Company purchased a set of electrical equipment from Futaixiang Ltd. and then rented them to Qin Shan Ltd. One year later Huaiyuan agreed to sell the equipment to Qin Shan. Their agreement provided that Huaiyuan assigned the rights in its contract with Futaixiang to Qin Shan Ltd. The equipments were later found to be defective. The assignment was considered invalid because Huaiyuan had not informed Futaixiang Ltd about it. The court held that the agreement about the release of Huaiyuan's obligation to Qin Shan was also invalid because Qin Shan agreed to purchase the equipments based on the knowledge that he would also get valid rights in the contract between Huaiyuan and Futaixiang. The decision was that Huaiyuan should compensate for Qin Shan's loss, and Huaiyuan therefore could

⁵⁹⁰ See Duan Chongzhi "Analysis And Evaluation Of Typical Civil Cases", Law Press, 2001, p275

⁵⁹¹ The case is decided in 2000. See Zhu Mingshan: "Typical Cases and Application of Statutes – Contracts for sale", Law Press 2003, p.193 - 207

recover it from Futaixiang. The analysts urged that a better approach could be adopted for Qin Shan Ltd to recover damages in his own name because had Huaiyuan become bankrupt or gone out of business, it would cause injustice to Qin Shan. Calls for the reform made by the judiciary in cases were based on the same reason as in the cases in England. For example, in *Beswick v Beswick*,⁵⁹² the widow, as an administratrix of her husband's estate was able to sue, but only nominal damages were available to her, while as an intended beneficiary in the contract, who suffered loss as a result of breach of contract the widow had no right to claim contractual remedies. In *Woodar Investment Development Ltd. v Wimpey Construction UK Ltd.*,⁵⁹³ Woodar contracted to sell some land to Wimpey, and they agreed that part of the contract price would be paid to a third party on completion. Woodar made a claim under the contract by reason that Wimpey did not pay the money. Wimpey pointed out that Woodar would have no claim for the third party's loss according to the privity doctrine. Lord Salmon regarded the law concerning damages for loss suffered by third parties as most unsatisfactory and hoped that, unless it were altered by statute, the House of Lords would reconsider it.⁵⁹⁴ Lord Scarman reminded the House that twelve years had passed since Lord Reid in *Beswick v Beswick* had called for a reconsideration of the rule, and hoped that all the cases which "stand guard over this unjust rule" might be reviewed.⁵⁹⁵ In *Forster v Silvermere Golf and Equestrian Centre Ltd.*,⁵⁹⁶ the plaintiff transferred her owned property to the defendant, who undertook to build a house for her and her children who could live there rent-free for life. The plaintiff recovered damages for her own loss when the defendant broke the undertaking, but she could not recover damages for her children's loss. Dillon J. referred to the effects of *Woodar* in the case before him as being a blot on the law and thoroughly unjust.⁵⁹⁷

⁵⁹² [1968] AC 58, 72

⁵⁹³ [1980] 1 WLR 277

⁵⁹⁴ [1980] 1 WLR 277, 291

⁵⁹⁵ [1980] 1 WLR 300; Law Commission No 242, par. 2.64, 36

⁵⁹⁶ (1981) 125 SJ 397

⁵⁹⁷ Law Commission No 242, par. 2.65, 36

6.2 The application of the English 1999 Act

6.2.1 The test of enforceability

The 1999 Contracts (Rights of Third Parties) Act in England confirms that the full range of contractual remedies are applicable for the third party beneficiary: "...there shall be available to the third party any remedy that would have been available to him in an action for breach of contract if he had been a party to the contract (and the rules relating to damages, injunctions, specific performance and other relief shall apply accordingly)". The measure of the third party's remedies is to put him in the position as if the contractual obligations had been properly performed - both the third party's reliance interest and expectation interest are protected by the law.⁵⁹⁸

However, the condition for a third party to take advantage of the 1999 Act is that he is within the scope of third party beneficiaries according to the test of enforceability, which requires that the contracting parties must not only intend that the third party should receive the benefit of the performance of the promise but also intend to create a legal obligation enforceable by the third parties. The test consists of two limbs. Under the first limb, section 1(1)(a) of the Act, the contract is for the benefit of a third party if the contracting parties expressly state the third party has the right to enforce the contract. In the absence of the parties' express intentions, the second limb of the test should be applied. Under Section 1 (1) (b) where the contract purports to confer a benefit on a third party, then the third party is able to enforce the contract. However, by subsection 1(2) the above provision is not applied if the promisor proves that on a proper construction of the contract the parties do not have the intention to create an enforceable right for the third party. Furthermore, according

⁵⁹⁸ Treitel in Peter Birks (ed.), *English Private Law* (Oxford 2000), para. 8.04

to s1(3) of the Act, no matter which limb is applied, the third party must be expressly identified in the contract by name, as a member of a class or as answering a particular description, but need not be in existence when the contract is entered into.

6.2.2 The application of the Act in some past cases

The application of the provisions to classic contracts for the benefits of third parties, such as *Beswick v Beswick*, *Woodar Investment Development Ltd. v Wimpey Construction UK Ltd* and *Forster v Silvermere Golf and Equestrian Centre Ltd*, made the third party beneficiary able to recover their loss in their own names because in the above cases, the contract purported to confer benefits on the third parties, who were expressly identified. However, the question is whether the new third party rule could resolve all the problems in previous cases concerning the third party's loss as a result of breach of contract.

6.2.2.1 Construction cases

In *Linden Gardens Trust Ltd. v Lenesta Sludge*⁵⁹⁹ Stock Conversion, as the owner of a leasehold interest in property, entered into a contract for the removal of asbestos from that property. After the work was done, it was found that asbestos was still present. Then Stock Conversion entered into a contract with another contractor for the removal of the remaining asbestos. It claimed damages against the first contractor for the cost of the remedial works together with associate loss and expenses. Later Conversion assigned its interest in the property to an associated company Linden Gardens at full market value, and also assigned all rights of action to the latter so that Linden Gardens became the plaintiffs. If the assignment was valid, Linden Gardens would win the case as they claimed as assignees. The Court of Appeal held that the assignment was valid; however the House of Lords held that assignment was invalid because it was

⁵⁹⁹ (1993) 3 All ER 417

prohibited under the contract. The application of the 1999 Act in such a situation could be rebutted because the assignment prohibition clause in the contract revealed that the contractor had no intention to confer a benefit or right of action on the third party.

*St. Martins Property Corporation Ltd v Sir Robert McAlpine Ltd*⁶⁰⁰ concerned a claim for loss suffered by the subsequent purchaser of the development site as a result of breach of a building contract. The employer, St. Martins Property Corporation, contracted with Sir Robert McAlpine & Sons Ltd for construction of a development. Later St. Martins Corporation passed their proprietary right in the development to an associated company, St. Martins Property Investments. St Martins Corporation also sought to assign the rights in the contract to the latter although the contract contained a prohibition on assignment. The construction work was found defective. The cost of repair was paid in the first instance by St. Martins Corporation but recovered by them from Investments later. Different from the *Linden Gardens* case, the breach of the contract happened after the assignment. The contractor argued that the employer had no right to recover cost of cure damages because he had no proprietary right in the subject matter of the contract at the time of the breach. The assignee who had the proprietary interest could not bring an action because he had no right to sue the contractor for his breach of contract. The problem that the remedy and the loss are separate in this way is the so called 'black hole' problem. The House of Lords solved the problem by allowing employers to recover damages in respect of building owners' loss. In this case, although it was true that the contractor could foresee that the development site would possibly passed to a third party, by subsection 1 (2) of the 1999 Act the presumption that the contracting parties had intention to create a benefit for the subsequent owner was rebutted because the assignment of the rights in the contract was disallowed.

⁶⁰⁰ [1994] 1 AC 85

In *Darlington BC v Wiltshier Northern Ltd*,⁶⁰¹ Wiltshier, a construction company contracted with Morgan Grenfell to build a leisure centre for Darlington BC which was the owner of the site. The council had employed an intermediary because there were restrictions on local authority borrowing. Morgan and Darlington made a covenant agreement which provided that Morgan assigned all the rights in the building contract to Darlington and Morgan would not be responsible for any incompleteness or defect in the construction work. Another tripartite deed among the three parties was entered into, giving the council direct contractual rights against Wiltshier for liquidated damages if Wiltshier failed to complete the construction on time. The council claimed that serious defects were found in the building and therefore it would incur substantial expenses in carrying out the repairs to remedy the defects. Morgan Grenfell suffered no loss as the result of Wiltshier's breach of contract because it had no interest in the land or buildings and also held no responsibility to the building owner for defects in the construction work. Since the assignee could not recover more than the assignor would have done, it was argued that Darlington could recover no more than nominal damages. Steyn LJ suggested that the building owner could have sued under the contract as a third party beneficiary.⁶⁰² However, such an approach was doubted by reason that the contracting parties' intention to confer a benefit on Darlington was rebutted by the assignment agreement between Morgan and Darlington – the parties chose to deploy an assignment technique. Had the contracting parties intended to confer any direct rights on the third party, they would not have provided for an assignment of the rights under the building contract.⁶⁰³ Indeed it was argued the fact that Morgan entered into the agreement with Darlington to assign its rights under the building contract meant the parties chose assignment mechanism and avoided making Darlington as a third party beneficiary – the parties might prefer the certainty of a comprehensive assignment clause to the

⁶⁰¹ [1995] 1 WLR 68

⁶⁰² [1995] 1 WLR 68, 76

⁶⁰³ Hannes Unberath, *Transferred Loss – Claiming Third Party Loss in Contract Law*, Hart Publishing (2003), p32

uncertainty of a direct right of action of doubtful scope.⁶⁰⁴ However, assignment was just the technique the parties had chosen, the true intention of assignment was to enable the building owner to get the benefits and rights under the building contract. It is not convincing to infer the parties' intention only from the technique they choose regardless what the parties' expectation really is. If Morgan and Darlington had known that the result of assignment would be that Darlington would recover no more than nominal damages, they would not have chosen assignment. Especially if the 1999 Act had been in force at the material time, they would choose the third party rule than assignment. In addition, the tripartite deed, which expressly gave Darlington a direct right to claim damages, was made as supplemental to the building contract. This further confirmed the employer, the contractor and the building owner had such an intention. Therefore the 1999 Act could be applied in such a case, because on a proper construction of the contract, no contrary facts indicated that the parties did not intend the contract to be enforced by the third party.

In *Alfred McAlpine Construction Ltd v Panatown Ltd*,⁶⁰⁵ Panatown employed McAlpine to build a building on land owned by UIPL. Panatown and UIPL were members of the Unex group of companies. Panatown was chosen to enter into the building contract for avoidance of tax. Its main obligation was to procure the contract but it was not responsible to other members of the group in respect of defects in the building or delayed completion of the construction work. In addition to the building contract, McAlpine entered into a Duty of Care Deed with UIPL, which provided that UIPL, as building owner, acquired a direct remedy against McAlpine in respect of any failure by McAlpine to exercise reasonable skill, care and attention in respect of any matter within the scope of McAlpine's responsibilities under the building contract. The construction was defective. McAlpine argued that Panatown was not entitled to recover substantial damages under the building contract because, Panatown having no proprietary interest in the site, it suffered no loss. The application of the 1999 Act in

⁶⁰⁴ Ewan McKendrick, "Breach of Contract and the Meaning of Loss", [1999] CLP 37, 56

⁶⁰⁵ [2001] 1 AC 518

this case is doubtful. Indeed, the Duty of Care Deed formed an integral part of the package of arrangements which the employer and the contractor agreed upon, and in that respect it should be viewed as reflecting the intentions of all the parties engaged in the arrangements that the third party should have a direct cause of action.⁶⁰⁶ However, the Duty of Care Deed provided only a limited remedy to the building owner. The limited remedy was subsidiary to that which arose under the building contract; for example, the remedy in the building contract did not depend on proof of negligence. The difference in substance between the remedies available under the contract and those available under the Duty of Care Deed makes the Act inapplicable by reason that the contractor only intended to allow the building owner to acquire the right under the DCD but did not intend them to enforce the building contract.

6.2.2.2 Junior Books v Veitchi Co Ltd

In *Junior Books v Veitchi Co Ltd*,⁶⁰⁷ the contractor had undertaken to build a factory for Junior Books. Later Junior Books nominated Veitchi as flooring subcontractor. The contract between the contractor and subcontractor provided that Veitchi undertook to lay the floor. Later the floor cracked due to Veitchi's negligence in doing the work. The subcontractor was held liable to the building owner for his negligence in laying the floor although the defective work did not cause any physical damage or loss of property. The decision was made in particular due to the 'very close proximity' between the parties. The special factors under consideration were: the subcontractor was nominated by the employer; the subcontractor was a specialist in flooring and knew of the employer's requirements; the employer relied on the subcontractor's skills in laying floors; the subcontractor must have known that defects in the work would necessitate repairs and lead to economic loss.⁶⁰⁸ It may be argued that the case

⁶⁰⁶ [2001] 1 AC 518, 532

⁶⁰⁷ [1983] 1 AC 520

⁶⁰⁸ [1983] 1 AC 520, at 546

could have been resolved by a rule about third party rights, because the contract between the contractor and subcontractor purported to confer benefits on the employer, who were presumably expressly identified as beneficiaries. However, unless the contractor and subcontractors expressly agree to allow the employer to enforce the subcontractor's obligations, the presumption of an enforceable right may be rebutted according to the construction of the chain of contracts between the parties, because in such chains, parties normally intend to keep their rights and obligations within their own contract.⁶⁰⁹

By the same reason, in other types of contract chain, for example the contract chains for sale of goods, lease or carriage of goods, the parties who finally receives defective goods, defective property or unsatisfactory service cannot take advantage of the 1999 Act to bring actions against the parties on the other end of the chain who have no contractual relationship with them. Although such exclusion was criticised for relying on 'vague unarticulated beliefs' assumed to be held in the construction industry,⁶¹⁰ it is correct to conclude that in the situation of contract chains the parties do not have intentions to create direct enforceable rights for the third parties unless they expressly agree to do so.

6.2.2.3 Negligent Will-Drafting

Another important case concerning the third party's remedies is the situation where a solicitor negligently fails to draw up a will thereby causing loss to the intended legatees of the will.

In *Ross v Caunters*,⁶¹¹ the testator instructed his solicitors to prepare a will which included a gift to the testator's sister-in-law Mrs Ross. The solicitor failed to warn the

⁶⁰⁹ Law Commission No 242, par. 7.47

⁶¹⁰ M Bridge [1996] JBL 602, 605

⁶¹¹ [1980] Ch. 297

testator that an attestation of a will by a beneficiary's spouse would invalidate a gift to the beneficiary according to the section 15 of the 1837 Wills Act. After the testator's death, Mrs. Ross was notified that a bequest to her of a share of estate was void for breach of the 1837 Act. Her claim for recovery of her loss of gift as a result of the solicitor's negligence was upheld.

*White v Jones*⁶¹² has similar facts. The testator instructed his solicitor to make a new will under which he would leave substantial proportion of his estate to his daughters. However, the testator died before the execution of his new will and without effectively revoking his prior will. The House of Lords held that the solicitors owed a duty of care to the disappointed intended beneficiaries.

In answering the question whether as third party beneficiaries, the disappointed legatees can sue the solicitors who negligently fail to draw up a will properly. The House of Lords thought that the facts of *White v Jones* would not naturally fall within a *jus quaesitum tertio*. Lord Goff held:⁶¹³

Even if we lacked the former (consideration) and possessed the latter (*jus quaesitum tertio*), the ordinary law could not provide a simple answer to the problems which arise in the present case, which appear at first sight to require the imposition of something like a contractual liability which is beyond the scope of the ordinary *jus quaesitum tertio*.

Lord Mustill said:⁶¹⁴

But even under a much expanded law of contract it is hard to see an answer to the objection that what the testator intended to confer on the new beneficiaries was the benefit of his assets after his death; not the benefit of the solicitor's

⁶¹² [1995] 2 AC 207

⁶¹³ [1995] 2 AC 207, 262-263

⁶¹⁴ [1995] 2 AC 207, 723

promise to draft the will.

The Law Commission Report suggested that the negligent will-drafting cases would not be included in the reform of privity. The test of enforceability requires that the promise should be the one to confer a benefit on the third party – the solicitor's express or implied promise to use reasonable care while drafting the will is not meant to confer a benefit on the third party, but is meant to enable the testator to 'confer a benefit' on the beneficiary.⁶¹⁵

It is true that when a solicitor enters into the contract and promises to draft an effective will for the testator, he has no intention to create an enforceable right for the legatees. Therefore the legatees were not intended to enforce the contractual obligations: to claim drafting of the will, although the beneficiary would subsequently get the benefits from the performance of these obligations as a result. Therefore the 1999 Act is not applied in cases concerning disappointed legatees' loss.

6.3 The third party rule and existing problems

6.3.1 Role of the third party rule

As discussed in chapter three, the dual intention test is the best one to be adopted if the Chinese Contract Law reforms the third party rule. This is because the dual intention test matches the purpose of Chinese Contract Law and the fundamental principle – to protect contracting parties' lawful rights, realize their expectations in transactions and effectuate freedom of contract. Therefore, the criterion which decides when a third party has a right to enforce a contract is suggested to follow the English 1999 Act. However, from the above discussion, it shows that problems in many cases

⁶¹⁵ Law Commission No 242, para 7.20

cannot be resolved by the 1999 Act. This is for several reasons:

First, under the dual intention test, the intention to confer a benefit on a third party must be both the parties' will. The fact that only the promisee has the intention to confer a benefit on a third party is not enough for the latter to take the advantage under the Act. For example, A contracted with B to order a set of furniture. After the furniture was made, A requested B to deliver it to C and at that time B realized that it was A's gift for C. Since C was not disclosed as a beneficiary when the contract was entered, B's subsequent agreement to deliver the goods to C could at the most be seen as showing that he intended to allow C to get the benefit from receipt of the goods, but did not intend to allow C to sue on the contract if the furniture was defective. In the *St Martins* case, the employer had the intention to allow the subsequent owner of the building enjoy the benefits and rights under the building contract, and the employer did try to effectuate such an intention through an assignment agreement with the subsequent building owner. However, these facts would not enable the building owner to use the Act because from the assignment prohibition provision in the building contract the contractor had no intention to confer benefits on the subsequent building owner or allow him to enforce the building contract. Similarly, in the *Panatown* case, the employer entered into the building contract for the construction work on the third party's land. The reason why the employer, instead of the landowner, was chosen to enter into the contract was to reduce the tax burden. The employer was not answerable to other members of the group in respect of defects in the building. Obviously the employer intended to confer benefits and rights in the building contract to the building owner. But the application of the 1999 Act could be rejected by reason that the contractor had no intention to allow the building owner to enforce the building contract although he had intention to let the owner to get a remedy from Duty of Care Deed. Lord Goff held that even if the 1999 Act had been in force at the material time, it would not have given the third party, the building owner, any right to enforce the building contract, or any provision of it, against the employer, because the building contract did not expressly allow the building owner to enforce

the contract and there was no term in the contract purporting to confer a benefit on it.⁶¹⁶

In the Chinese case *Qin Shan Ltd. v Huaiyuan Electric Company and Futaixiang Ltd.*,⁶¹⁷ Huaiyuan Electric Company purchased a set of electrical equipment from Futaixiang Ltd. and then rented them to Qin Shan Ltd. One year later Huaiyuan agreed to sell the equipment to Qin Shan. The assignment which provided that Huaiyuan assigned the rights in its contract with Futaixiang to Qin Shan was considered invalid because Huaiyuan had not informed Futaixiang Ltd about it. The proposed third party rule could not be applied in this case because the promisor did not have an intention to allow the third party to enforce the contract. In the lease contract case *Li Xuan & Wang Yafang v. Tieda Real Estate Development Corporation*,⁶¹⁸ the tenant's wife who became ill because of contaminated water could not sue the landlord on the contract because the landlord did not have an intention to allow her to enforce the contract.⁶¹⁹

Secondly, the 1999 Act also provides a third party beneficiary must be identified in the contract. Therefore, without identification of the third party, even if it can be presumed from the contract and surrounding circumstances that the parties have intentions to confer benefits on a third party, the 1999 Act will not be applied. This indeed excludes the Act from being applied in some cases, for example, a father who entered into a contract with B to build a garden behind his daughter's house. The daughter was not expressly identified in the contract although during performance of the construction work B was aware that the work was done for the daughter's benefit.

⁶¹⁶ [2001] 1 AC 518, 560

⁶¹⁷ Zhu Mingshan: *Typical Cases and Application of Statutes – Contracts for sale*, Law Press 2003, pp.193 – 207

⁶¹⁸ See Ma Qiang: "The Contract for Protecting third parties", www.civillaw.com.cn/research/justice/default.asp, 12 Feb 2003; Financial Law Forum, <http://fol.math.sdu.edu.cn/jrfy/content/content.php?id=76&tb=dxal>

⁶¹⁹ It is better to solve the problem by tort law in China.

In China, under the dual intention test, the third parties will not take advantage from the proposed reform in the cases such as *Spinning Mill v Kelun Cotton Mill & Jianshe Cotton Mill*⁶²⁰ and *Maoyi Corporation v. Tucan Company & Susu Clothing Factory*.⁶²¹ In the *Spinning Mill* case, Kelun ordered spinning material from Jianshe, and entered into another contract to sell the to goods Spinning Mill. Later Kelun requested Jianshe to deliver the goods to Spinning Mill. Kelun also promised Spinning Mill to assign it the benefits under the contract with Jianshe. Jianshe failed to deliver the goods. The difficulty arose from the agreement between Kelun and Spinning Mill which released Kelun's liability to the latter. The *Maoyi* case had the similar facts: the right to receive the goods was assigned from Susu to Maoyi but no express term stated that Susu assigned its rights of claim under the contract to Maoyi. Although it was argued that the promisees must also have had an implied intention to assign the right of claim to the buyers,⁶²² even if this was true, the buyers would not take the benefit from the third party rule. This is because in both cases the promisees' buyers were not identified in the contract between the promisees and the promisors.

Thirdly, the application of provisions of the 1999 Act to difficult cases will in itself be controversial. For example, in the *Panatown* case, the dispute on application of the 1999 Act arose from the different substance of the rights given in the Duty of Care Deed, which may indicate that the contractor did not have the intention to allow the building owner to enforce the building contract.⁶²³ However, on the other hand, the whole arrangement of the parties, the contractor's knowledge that the third party was the building owner, indeed allowed it to have direct remedies in respect of negligence in doing the construction work; and the contractor's awareness that the

⁶²⁰ Wang Liming: Case studies in Chinese Civil Law, Law Press 1998, p148.

⁶²¹ Wang Liming: Case studies in Chinese Civil Law, Law Press 1998, p241.

⁶²² See Para. 2.2.1.1 above.

⁶²³ The majority's view in the *Panatown* case was they were not dealing with a black hole case because the party sustaining loss had the benefit of the duty of care deed which could found action against the contractor.

employer entered into the contract like a intermediary and would not be responsible for defects in the building, may suggest that the Act could be applied in this case because the aim of the dual intention test is to respect and realize the parties' original true intentions instead of mechanically limiting the inference of their intentions within the words which are expressed in the documental material.

6.3.2 Black hole problem of characterisation

The problem existing in the above English building contracts cases in which promisees have the right for remedies but suffered no loss, whereas third parties suffer loss but have no right to remedies is called the 'black hole' problem. Such a problem characterised as separation of the right to remedies and the loss arises because the whole or part of the promisee's expected interests are transferred from the promisee to the third party. Therefore, the outcome of the promisor in performing the contractual obligations directly affects the third party's interest – the third party will get the benefit from the promisor's satisfactory performance or will suffer a loss as a result of his breach of contract. On the other hand, the promisee, after transferring the substantial expected interest, suffers no substantial loss as the result of the promisor's breach of contract so it can recover nominal damages only.

Generally speaking, the black hole problem is likely to arise in two circumstances. One situation is that the right in the subject matter of the contract is transferred from the promisee to the third party before the contract ends, and the third party therefore gets its expected interest in the performance of the contract. The problem normally arises where a promisor fails to provide satisfactory service or work on the subject-matter of the contract and therefore the third party, as an owner, suffers the loss but cannot claim on the contract due to the privity doctrine. The typical case is *St Martins*, where the employer transferred its proprietary right in the development to its associated company during the performance of the contract and also assigned the benefits of the contract to the latter. The assignment of the contractual rights was

invalid because the building contract contained prohibitions on assignment. The third party, as the new building owner, suffered the loss as the result of the defective construction work, but did not have the right to claim damages under the building contract in its own name. The same problem could happen in other types of contracts, such as contracts for carriage of goods, contracts for work and contracts for service. For example, A who owns sets of flue boilers employs B to improve them to forced-flow boilers; during the performance of the contract, A transfers the proprietary right of the boilers to C, and also assigns the benefits and rights under the contract to C. Assignment of the rights of the contract is invalid for some reasons, say an assignment prohibition due to the secret technology, so C cannot claim damages on the contract if the finished boilers are defective. The similar problem can even happen in contracts for sale. For example, in the *Qin Shan Ltd. v Huaiyuan Electric Company Futaixiang Ltd*, the promisee ordered the products from the obligor and later sold them to a third party. The obligee also agreed to assign the benefits (benefits of warranties and technical assistance) and rights under the contract to the third party. The assignment was invalid because the obligee did not inform the obligor about the assignment.

Another situation is where a third party has the proprietary right of the subject matter of the contract from the outset. The promisee enters into the contract with the intention that the third party will later acquire the benefits and rights of the contract. But the promisee is neither the third party's agent nor trustee. If the promisor's service or work is done unsatisfactorily, the third party, who suffers the loss, can get no more than nominal damages under the assignment rule because the promisee has no proprietary right in the subject matter of the contract when it assigns the right of claim to the third party. In the *Darlington* case, the employer entered into the contract for the construction work on the third party's land. The employer assigned the benefits and rights in the building contract to the third party. The third party suffered the loss because the construction work was defective, but as an assignee it could recover no more than nominal damages. There may be some other cases where third parties, who

own the subject matter of contracts, stand to gain from the performance of the contract; however the rights and benefits they acquire from promisees through assignment will not enable them to claim substantial damages. For example, A employs B to repair his daughter's house, and later A transfers the benefits and rights in the contract to his daughter in order that the daughter can claim on the contract if the repair work is found unsatisfactory in the future. Assignment of A's right of claim to the daughter could be nominal only. Company A occupies the ship which belongs to its associated company C; A enters into a contract with B and B promises to reconstruct the ship in order to prolong its life of service. Later A returns the ship to C and also assigns all the benefits and rights of the contract to C. C, as the assignee, can get no more than nominal damages if the reconstruction work is defective.

A necessary factor to cause the black hole problem in both situations is that the promisee is no longer responsible to the third party for the promisor's unsatisfactory work or service. Otherwise, the promisee still has the right to claim substantial damages because he suffers the loss – the loss is the cost he incurs to remedy the third party's loss as the result of the promisor's breach of contract.

6.3.3 Solutions in English law

The general principle is that the plaintiff can claim damages for his own loss only. However, in order to avoid an unsatisfactory result of the application of this rule, a number of exceptions have been created in English Law. For example, a trustee can recover substantial damages for breach of contract in respect of the loss of his *cestui que trust*; an agent can claim damages for his undisclosed principal's loss; and a local authority can recover damages for the loss suffered by its inhabitants.⁶²⁴ Earlier cases concerned 'special treatment' such as a person who reserves package travel for their family or books a dinner for their relatives or friends: the promisees are entitled to

⁶²⁴ Treitel, *Law of Contract*, 10th Ed., 1999, pp550-551

recover substantial damages in respect of their family's or friends' loss and the claim should be raised on behalf of these third parties.⁶²⁵ Such an exception was described in an earlier commercial case *Dunlop v Lambert*.⁶²⁶ Later in *The Albazero*⁶²⁷ case the application of the exception was created. The exception first established in these cases was applied at the beginning only in commercial cases, such as contracts of carriage of goods in which the parties could reasonably anticipate that the subject matter of the contract would be transferred to a third party during the performance of the contract.

The exception to the principle that the plaintiff can only recover damages in respect of his own loss later extended to be applied in building contract cases such as *St. Martins Property Corporation Ltd v Sir Robert McAlpine Ltd*⁶²⁸ and *Darlington Borough Council v Wiltshier Northern Ltd*.⁶²⁹ In each case substantial damages in respect of third parties' losses were awarded. The House of Lords offered two grounds to explain their support of the promisee's substantial damages in respect of the third party's loss.

6.3.3.1 Narrow Ground

In *St Martins*, the breach of contract occurred after the property right in the development was passed to its associated company. The employer was not liable for the defects in the building and recovered the cost of effectuating the repairs from the transferee, so the employer suffered no loss himself. Since the assignment of action under the building contract from the employer to the new building owner was invalid, the latter who suffered loss could not claim damages in its own name. The question was whether the employer could recover substantial damages in respect of the building owner's loss. Lord Browne- Wilkinson put his judgment on the ground of

⁶²⁵ Treitel, *Law of Contract*, 10th Ed., 1999, pp552

⁶²⁶ (1839) 2 Cl. & F. 626

⁶²⁷ [1977] AC 774

⁶²⁸ [1994] 1 AC 85

⁶²⁹ [1995] 1 WLR 68

extended application of the principle set up in the two previous cases: *Dunlop v Lambert* and *The Albazero*. These established a mercantile principle in carriage of goods by sea. The requirements to apply the principle in construction contracts are that the parties could foresee or contemplate the benefit or interest of the third party in the subject matter of the contract, and impliedly accept the employer's right to recover substantial damages on behalf of the third party for his loss.⁶³⁰

The narrow ground was also cited in the *Darlington* case to solve the black hole problem where the employer suffered no loss and was not liable for defective construction work to the building owner, whereas the building owner suffered loss but as an assignee could recover no more than nominal damages. The difficulty in using the narrow ground was that in the *Darlington* case the promisee never had a proprietary interest in the development so there was no transfer interest in the subject matter of the contract. However, it was argued the fact that the transfer of proprietary right in the building did not occur in the *Darlington* case was not the reason to deny the application of the narrow ground.⁶³¹ It was argued that in the *Darlington* case it was more obvious that the contracting parties could foresee or contemplate that the building was constructed for the benefit of the building owner.⁶³² But since the building owner in the equivalent case could take advantage from the 1999 Act and claim damages in his own name, there is no necessity to use the narrow ground to solve the black hole problem. In addition, under the principle established in the *The Albazero*, the building owner's direct claim against the builder excluded the application of the narrow ground.

In the *Panatown* case, the employer did not have a proprietary right in the building from the outset and was also not answerable for the defects in the building.

⁶³⁰ [1994] 1 AC 85, at 113, 114, 115; Duncan Wallace, *The Third Party Damages: No Legal Black Hole*, (1999) 115 LQR, at 396

⁶³¹ [1995] WLR 68, 75

⁶³² [1995] 1 WLR 68, 75

The builder and the building owner entered into a Duty of Care Deed under which the building owner acquired a direct remedy against the builder in respect of any failure by the builder to take care or exercise reasonable skills. Lord Clyde, Lord Jauncey of Tullichettle and Lord Browne-Wilkinson accepted that the narrow ground could be applied in principle but the express provision of the direct remedy for the third party was fatal to the application of *The Albazero* exception – the parties’ intention was to give a direct remedy, not let the employer recover substantial damages in respect of the building owner’s loss.⁶³³ Lord Goff and Lord Millett regarded the narrow ground as inappropriate by reason that there was no transfer of proprietary right in the building from the employer to the third party.⁶³⁴

6.3.3.2 Broad Ground

The broad ground was another approach proposed in English cases to resolve the ‘black hole’ problem. It is based on the ‘promisee’s performance interest’, which states that the promisee is entitled to substantial damages if the promisor fails to carry out promises because the promisee does not receive the bargain for which he has contracted. The essence of this reasoning is that the promisee recovers damages in respect of the loss which he himself suffered in ensuring that the third party receives the intended benefit.⁶³⁵ In the *St Martins* case, Lord Griffith supported the employer’s claim by the reason that “the employer had suffered financial loss because he had to spend money to give the third party the benefit of the bargain which the defendant had promised but failed to deliver.”⁶³⁶ Again, in the *Panatown* case, Lord Goff and Lord Millett sought to base their judgment on the broad ground. Lord Goff held that in a case like *Panatown*, the broad ground, instead of the 1999 Act, could be applied even

⁶³³ [2001] 1 AC 518, 530 (Lord Clyde), 566 (Lord Jauncey of Tullichettle), 575 (Lord Browne-Wilkinson)

⁶³⁴ [2001] 1 AC 518, 545 (Lord Goff), 585 (Lord Millett)

⁶³⁵ Treitel, *Law of Contract*, 10th Ed., 1999, pp552

⁶³⁶ [1994] 1 AC 85, 97

if the Act was in force in material time.⁶³⁷

6.3.3.3 Problems of English Solutions for Solving the Black Hole Problem

Both the narrow and the broad grounds try to solve the black hole problem by allowing promisees to claim substantial damages covering the loss of third parties. The problem arises from the separation of the right to remedies and the loss.

First, the broad ground, in order to justify the promisee's claim for substantial damages, explains that the loss is suffered by the promisee himself instead of the third party. The narrower explanation states that the promisee's loss occurs because he incurs or intends to incur expense in securing the benefit of a bargain.⁶³⁸ This means it does not require that the promisee has already paid for that cost before the claim is made. The broader explanation even goes further: the promisee is entitled to substantial damages regardless of whether it incurred expense in remedying the third party or has actually suffered the loss as a result of breach of contract. The central issue thus changes from 'how to resolve the third party's loss' to 'why the promisee should get substantial damages'. Hannes Unberath has analysed six drawbacks of the broad ground: for example the third party's consequential loss cannot be characterised as loss suffered by the promisee; it creates difficulties of loss quantification in third party loss cases; and by characterising the loss as that of the promisee it encounters difficulties of explaining that the award of damages will be in one form or another beneficial to the third party.⁶³⁹

Secondly, the narrow ground answers the question why the promisee should be entitled to substantial damages in respect of the third party's loss. In *St Martins*, the

⁶³⁷ [2001] 1 AC 518, 560

⁶³⁸ [1994] 1 AC 85, 97

⁶³⁹ Hannes Unberath, 'Transferred Loss – Claiming Third Party Loss in Contract Law', Hart Publishing (2003), p61

employer was awarded substantial damages based on the narrow ground. Comparatively, the narrow ground is better than the broad ground to solve the cases like *St Martins* because the former overcomes the difficulties in explaining why the new building owner's consequential loss could be recovered through the old building owner's action and why the awarded damages ought to be handed over to the new building owner. However, some problems still remain in applying the narrow ground – in what way the new building owner can compel the old owner to pass on the awarded damages, and whether he has a special claim to that money ahead of the old owner's other creditors in the event of that party becoming insolvent before the money is actually transferred.⁶⁴⁰

6.3.4 Application of English solutions in the recent Scottish cases

Whether the narrow ground could be adopted in Scotland to solve the black hole problem was discussed in some recent Scottish cases. In *McLaren Murdoch & Hamilton Ltd v The Abercromby Motor Group Ltd*,⁶⁴¹ the plaintiff, a firm of chartered architects, sued the defendants for professional fees in relation to the design and construction of a number of car showrooms. The defendants brought a counterclaim for damages alleging negligence on the part of the plaintiffs in particular in relation to the design of the heating system. The plaintiffs argued that the defendants suffered no loss because the cost of replacing the heating system was paid by another company, Carden Investment Ltd. There was an agreement between the defendants and the third party, Carden, that when the properties were transferred to Carden, the defendants discharged all liabilities related to the properties before a certain date and Carden discharged all such liabilities after that date. At the time when the loss was sustained, the building was still the property of the defendants, but the necessary repair work was paid by Carden after the property had been transferred. The principle of *jus quaesitum tertio* in Scots law cannot be applied in this case because the contracting

⁶⁴⁰ Hector L MacQueen and J. M. Thomson, *Contract Law in Scotland* (2000), p250

⁶⁴¹ [2003] SCLR, 323

parties must intend to benefit the third party and also the third party must be identified in the contract.⁶⁴² Lord Drummond Young held that the narrow ground applied by the House of Lords in the *St Martins* and *Panatown* could be taken to solve the black hole problem in the present case.⁶⁴³

I am accordingly of opinion that Scots law should adopt the same general rule as that applied by the majority of the House of Lords in that case (*Panatown*), as described by Lord Clyde in the passage quoted above. In effect the rule comes to this: if a breach of contract occurs, causing loss that can be measured in financial terms, the party who is not in breach may recover substantial damages even if that loss has been sustained by another person; if a loss has been sustained by a person other than the contracting party, however, the contracting party must sue on behalf of that other, and must accordingly account to that other for the damages recovered.

In another case, *Clark Contracts Ltd v The Burrell Co Ltd*,⁶⁴⁴ the plaintiffs were employed by the defendants as the main contractors in the redevelopment of eight flats in Glasgow. The employers were not the owners of the flats. The owners were The Burrell Co Ltd, a company within the same group of companies as the defendants. The plaintiff brought an action in order to claim payment from their employers under a construction contract, and the defendants brought counterclaims seeking liquidate and ascertained damages for the cost of making good defects in the work carried out by the contractors. The plaintiff argued that the defendants could not recover the loss because the defendants were not owners of the flats, so they suffered no loss. The defendants' counterclaim was not supported by the court which held that the third party, owners of the flats could claim damages in its own name, relying on the rule of *jus quaesitum tertio*. In this case, two formulations of the broad ground were rejected by the court. The 'narrow' broad ground was rejected by reason that the defendants

⁶⁴² [2003] SCLR, 323, 343

⁶⁴³ [2003] SCLR, 323, 344

⁶⁴⁴ [2003] SLT (Sheriff Court), 73

suffered no loss because they had no requirement to instruct remedial works, to pay the liquidated and ascertained damages to the owners of the flats or pay for the cost of rehousing the purchasers of the flats. The 'broader' broad ground was even doubted by the court whether it is a part of the law of England. As far as the narrow ground established in *The Albazero*, *St Martins* and *Panatown* is concerned, the court accepted it as a reasonable and practical solution but one that it was not necessary to introduce into the Scots law because the narrow ground was devised to remedy the black hole problem in English law arising because it does not recognise JQT, whereas that problem does not exist in Scotland.⁶⁴⁵

The broad ground was rejected in another recent building contract case, *Royal Insurance Ltd v Amec Construction Scotland Ltd and others*.⁶⁴⁶ This was because the third party's loss should not be treated as the plaintiff's unless the plaintiff had actually incurred that loss. In this case the plaintiff who was a tenant when the building owner entered the contract with the contractor, but the plaintiff, as prospective purchaser, obtained collateral warranties from the contractors. After the work was completed the plaintiff purchased the building. It later sold to another company but leased it back on a full repairing and insuring basis. Later the building needed repair and the remedial work was carried. At that time the plaintiff did not pay for the remedial work but based its claim on the agreements which provided that various third party payments were made *on the plaintiff's behalf* and the plaintiff were required to reimburse all their said group companies and agents in relation to all costs incurred. Lord Emslie held that the solutions crated in England to solve the black hole problem in cases such as *Linden Gardens* and *Panatown* would not be applied in this case and general rule was still to the effect that a plaintiff can only recover his own loss. The plaintiff could recover substantial damages only if he proved that he had *actually* suffered loss. In Lord Emslie's opinion, the reason that the plaintiff was answerable for the third party's loss was not enough for him to recover substantial

⁶⁴⁵ [2003] SLT (Sheriff Court), 73, 78

⁶⁴⁶ <http://www.scotcourts.gov.uk/opinions/2005CSOH162.html>

damages: “when the pursuer seek to bring themselves within the ordinary rule requiring the existence of an obligation to account, or obligation to reimburse before any claim can be made in respect of costs actually met by third parties, the critical question is whether the pursuers have relevantly succeeded in doing so, because otherwise it might prove more difficult to justify treating the disputed heads of loss as the pursuers’ own.”⁶⁴⁷

6.4 The third party’s loss remedies – comparative study

6.4.1 German law

6.4.1.1 Transferred loss

The problem in those cases where expected interest in the performance of contract has been transferred from a promisee to a third party and therefore when the promisor fails to perform its contractual obligations, the promisee suffers no loss whereas the third party suffers loss but cannot sue on the contract. The doctrine of transferred loss is meant to ensure that the promisor in the contract does not benefit from his fault in the above circumstance by allowing the promisee to claim damages in respect of the third party’s loss suffered as the result of breach of contract.⁶⁴⁸ The notion of transferred loss is established as an exception to the general rule in German law that every party to a contract may only recover his own loss. Similar to the English narrow ground established in the *St Martins* case, it is based on the reasoning that parties can foresee the transfer of subject matter to a third party and therefore they have in contemplation that the promisee has the right to claim damages in respect of the

⁶⁴⁷ <http://www.scotcourts.gov.uk/opinions/2005CSOH162.html>

⁶⁴⁸ Sir Basil Markesins, Hannes Unberath, Angus Johnston, “The German Law of Contract – A Comparative Treatise”, (2006) 2nd Edition Hart Publishing, at 217

subsequent owner's loss, the German notion is based on the assumption that the contract contains an implied term providing that the promisee is able to recover damages on behalf of the third party's loss. Such an assumption was found reasonable when it was applied in some German cases, for example, one concerning the carrier's entitlement to substantial damages for the owner's loss caused by a forwarding agent's fault,⁶⁴⁹ and other cases in which carriers breached the duty to take care of the goods and therefore owed liabilities to promisees although the loss was suffered by goods-owners who were not parties to contracts. However, the above reasoning was found unsatisfactory later when it was applied in contracts for sale, because normally it could not be inferred from those contracts that contracting parties had an implied intention to allow promisees to sue for damages in respect of the sub-buyers.⁶⁵⁰ In one German case, the plaintiff bought leather from the defendant and made it into belts. Most of the belts were sold to the firm KF. The leather was later found to be defective. KF suffered loss, but normally KF had made no claim for this sum against the plaintiff and the plaintiff did not contend that it was liable to KF. The Court of Appeal held that the plaintiff was entitled to sue for the loss suffered by its purchaser on the ground that the contract contained an implied term to enable the plaintiff to do so.⁶⁵¹ The decision was criticized by the German Supreme Court as using a fictitious intention of the parties because in this case the parties hardly had an implied intention that the plaintiff could sue for damages suffered by its purchasers, and the plaintiff's claim on behalf of the sub-purchaser even could not be predicted by the defendant.

Due to the above reason, the rationale of the notion of transferred loss does no longer stick to the interpretation of contracting parties' intentions but focuses on objective requirements for a promisee's claim in respect of a third party's loss. Therefore, under German law, exceptions are admitted in special cases where the loss

⁶⁴⁹ BGHZ 15, 224,

⁶⁵⁰ BGHZ 40, 91

⁶⁵¹ Sir Basil Markesins, Hannes Unberath, Angus Johnston, "The German Law of Contract – A Comparative Treatise", (2006) 2nd Edition Hart Publishing, at 218

that would ‘ordinarily’ be suffered by the promisee falls on a third party by reason of special legal relations between them.⁶⁵² According to the rationale, the loss suffered by a third party instead of a promisee does not need to be contemplated by the promisor, but depends on the special relationship between the promisee and the third party. The special relationship could be their agreement which provides that the promisee transfers the proprietary right of the subject matter as well as the benefits in the contract to the third party.

6.4.1.2 Contracts With Protective Effects Towards Third Parties

The theory of contracts with protective effects towards third parties was particularly developed by German law in order to cover a class of third parties within the protection by way of contractual actions. The reason why the German Courts use this approach is because the rule under article 831 BGB allows the master to avoid liability for the torts committed by his servants whenever he can prove that he selected and supervised them carefully. It is argued that in each contract there is a cluster of obligations, some of which are primary obligations while others are secondary or collateral obligations which often take the form of collateral duties of protection.⁶⁵³ Thus, in the case where A promised B that he would supply a certain service and A’s defective performance was likely to cause harm to C, especially cause danger to C’s life and health, then C was covered under the ‘protective umbrella’ of the contract and therefore had the direct right for damages against A. This rule was later extended to enable C to recover pure economic loss. In the mid-1960s, the notion of the contract with protective effects towards third parties was applied in disappointed legatee case.⁶⁵⁴ It was held that a disappointed legatee could recover his loss against the negligent notary because the disappointed legatee was the only person

⁶⁵² Hannes Unberath, *Transferred Loss – Claiming Third Party Loss in Contract Law*, Hart Publishing (2003), p126

⁶⁵³ Markesinis, *The German Law of Obligations, The Law of Contracts and Restitution: A Comparative Introduction* (1997), p276

⁶⁵⁴ BGH NJW 1965, 1955; JZ 1966

who suffered the loss as a result of the notary's breach of contract, and also the notary must have known that his timely performance of contractual obligations was crucial to both the testator and the legatee. Under the notion of the contract with protective effect towards third parties, it is held that in some cases promisors take secondary or collateral liabilities towards the third parties. For example, a notary is liable to his client to prepare an effective testament and is also liable to use reasonable care not to damage the legatee's prospective benefits in the testament. Based on the same logic, that promisors owe secondary liabilities to third parties. For example, professionals owe a duty of care to third parties who have reasonably relied on their services and are also likely to suffer loss as the result of negligent certifications or valuations. Subcontractors are liable to use reasonable care to do the construction work towards employers. Therefore in Germany in a case like *Junior Books*, the doctrine of contract with protective effects can apply.⁶⁵⁵ And the doctrine may also apply to a case like *Panatown* in which the contractor owes contractual liabilities to the employer and also owes a secondary liability – a duty of care to the building owner under the Duty of Care Deed, so that the building owner himself acquires contractual remedies.

6.4.2 French law

It is true that a third party obtaining a direct right of claim is more straightforward than a promisee's claim for damages in respect of the third party's loss. The only difficulty in applying this solution is the privity doctrine. It may be argued that in addition to the third party beneficiary rule which is justified on the point that contracting parties' intentions should be effectuated by the law, exceptions to privity could be established if justice requires it. In what circumstances the law should provide remedies for third parties beyond privity depends on the particular facts of cases. Exceptions could be created by the legislature or by a court regardless of whether the third party's remedies are in accordance with the parties' will. As Simon

⁶⁵⁵ Markesinis, W Lorenz, S Dannemann, *The German Law of Contracts and Restitution*, (1997) 280

Whittaker said:⁶⁵⁶

It is submitted that there is no reason in principle why the courts should not allow direct exceptions to privity where justice requires them, and in particular where they are demanded by the nature of the contract which the parties have made.

There is another notion in French law – the so called *action directe*, which is similar in its practical effects to the contract for the benefits of third parties but is based on entirely different justifications.⁶⁵⁷ It is argued that a third party can claim for remedies in his own name on the contract because he has a special interest in the performance of the contract. The special interest could be that the third party has or is going to have the right in the subject matter of the contract and therefore has a part or full expectation interest in performance of a contract. Article 1792 of the French Civil Code extends contractors, designers and engineers' liability to the persons who subsequently acquire an interest in the building. Under this provision, the sub-purchasers of the building are able to sue the contractor, and the employers have the right to sue the subcontractor. The same notion benefits the subcontractor who has done building work pursuant to a contract with the main contractor – if the main contractor becomes insolvent, the subcontractor can sue the site-owner directly for his unpaid fee to the extent that the main contractor's claims have not been met.⁶⁵⁸ The *action directe* is also applied in some other types of contracts such as house leases. If a tenant is in arrears with the rent the landlord can proceed directly against the subtenant.⁶⁵⁹

The notion of the third party's interest in the performance of a contract does not itself explain in what circumstances the third parties is regarded as having a special

⁶⁵⁶ Simon Whitaker, *Privity of Contract and the Tort of Negligence: Future Directions*, (1996) OJLS, 193

⁶⁵⁷ K. Zweigert & H. Kotz, *An Introduction to Comparative Law*, (3rd ed, 1998), p464

⁶⁵⁸ K. Zweigert & H. Kotz, *An Introduction to Comparative Law*, (3rd ed, 1998), p464

⁶⁵⁹ Article 1595, French Civil Code

interest. The standard to what scope the third persons are covered under the notion of *action directe* is directly imposed by the law. French laws provide that in some cases the third parties have direct rights against promisors on the contracts between promisors and promisees. For example, a principal has a direct claim against the third party to whom his agent has delegated the performance of the authorized task according to article 1994 par. 2 Code civil,⁶⁶⁰ a landlord can bring an action directly against the subtenant⁶⁶¹, a contractor can sue the site-owner if his employer has not paid wages nor received payment from the site-owner,⁶⁶² and likewise a subcontractor who has done his work according to the main contract can directly claim from the site-owner for his unpaid wages if the main contractor becomes insolvent.⁶⁶³

Other reasons for French law to recognise third parties' direct rights are particular types of contract and particular facts. Specific types of contract relate to particular purposes of certain transactions and relationships between parties, while particular facts give the reasons for the law to create exceptions to the general rules. In this regard, it is suggested that the courts should be able to create exceptions to the privity doctrine in relation to particular types of contracts the same way that they have historically felt free to regulate the relationship of the parties to particular types of contract.⁶⁶⁴

6.4.3 Chinese law

6.4.3.1 Statutes and Regulations Proving Remedies for Third Parties

In China, it has been established in some specific provisions which provide remedies

⁶⁶⁰ Article 1994 par. 2 Code civil

⁶⁶¹ Article 1753 Code civil

⁶⁶² Article 1798 Code civil

⁶⁶³ Article 12 Law of 31 Dec. 1975

⁶⁶⁴ Simon Whitaker, Privity of Contract and the Tort of Negligence: Future Directions, (1996) OJLS,

for third parties in particular circumstances. As to the relation between general laws and specific laws, the latter has priority to be applied in practice. There are many specific laws in China. As far as a construction contract is concerned, it is regulated by the general law such as the Chinese Civil Code and Contract Law, and also regulated by the specific laws: Construction Law, Regulation of Construction Quality⁶⁶⁵ and Regulation of City Land Development Business.⁶⁶⁶ Contracts for professionals' services are regulated by the specific statutes such as the Notary Law,⁶⁶⁷ the Audit Law⁶⁶⁸ and the Accountant Law.⁶⁶⁹ Like the French legal concept, the establishment of such statutes is based on the view that different transactions have different natures, trading customs and purposes, and therefore special provisions are established to regulate different types of contracts. Exceptions to the privity doctrine may be set up by the statutes according to the different types of contracts as well as the legislators' consideration about the nature of transactions including their aims to balance parties' interests and keep fairness. In addition, establishment of exceptions to the privity rule will not be confined within the current ones.

6.4.3.2 Third Persons in Action

In Chinese Civil Procedure Law, there are two rules which are frequently applied in practice – concerning a third person who has an independent claim and a third person who has no independent claim.⁶⁷⁰ Compared with the notion of *action directe* in French law, which requires that a third party must have a performance interest in the contract, the condition to make use of the above two rules is that a third person has a direct interest in the subject-matter of an *action* between the plaintiff and the defendant, that is, a third person may gain a benefit or hold a liability as a result of the

⁶⁶⁵ It was put into force in 2000.

⁶⁶⁶ It was put into force in 1998

⁶⁶⁷ It was put into force in 2005

⁶⁶⁸ It was put into force in 1995

⁶⁶⁹ It was promulgated in 2000

⁶⁷⁰ Article 56 of the Chinese Civil Procedure Law

action. The courts apply each notion, not only in order to combine two related cases together and short-circuit multiple lawsuits but also in order to avoid repeated claims and double liabilities for the same loss. The Chinese courts also make full use of third person in action rules to resolve the problem concerning a third party's damages caused by a promisor's breach of contract. Therefore, the difficulty caused by the privity doctrine could be overcome by parties' rights under the procedural law, and a third person is likely to be awarded substantive damages or hold substantive liabilities – the decision depends on the facts of cases.

In *Gansu Guo Huang Ltd v Gansu Disi Construction Company*,⁶⁷¹ Guo Huang Ltd employed Disi Company to rebuild the hotel which belonged to Guo Huang. After the construction work was completed, Guo Huang refused to pay the remaining outstanding payment because the construction work was seriously defective. Therefore Disi brought an action against Guo Huang, and the court held that Guo Huang was liable for payment in arrears and damages as well. In the decision, Guo Huang's right to claim damages for the defective work was not upheld on the ground that before the date of claim, the ownership of the hotel had been transferred to Northwest Kangyuan Group. Guo Huang appealed to a higher court. Kangyuan joined the action as a third person with an independent claim. Guo Huang argued that the construction work was seriously defective and they suffered loss because they were responsible for the defective construction work to Kangyuan Group. There was no evidence to prove that Guo Huang had transferred the right of claim under the building contract to Kuangyuan. Finally the court supported Guo Huang's averments that they were responsible for the defective construction and therefore held that Guo Huang could recover damages from Disi Construction Company, while Guohuang should pay damages to Kuangyuan in respect of Kuangyuan's loss suffered by the defective construction work.

⁶⁷¹ Zhu Mingshan, *Typical Cases and Application of Statutes – Construction Contracts*, Law Press (2004), 77

Another case, *WanXing Company v Dingsheng Ltd*,⁶⁷² concerned a sub-purchaser's loss caused by the processing factory's breach of contract. Huapu Ltd entered into the contract with Dingsheng Ltd and promised to do printing and dyeing work for Dingsheng's two tons of crimp cloth. Dingsheng accepted the finished cloth and made it into summer dresses. Some of the dresses were sold to Wanxing Company. Wanxing Company resold the dresses to a wholeseller in Vietnam. Import of the dresses was rejected by Vietnam Customs because a kind of heavy metal was found in the dyestuff of the dresses and the metal could cause danger to the human body. After refunding and paying damages to the wholeseller, Wanxing brought an action against Dingsheng for damages. However, the contract for sale between Wanxing and Dingsheng only defined the quality and quantity of the cloth but did not specifically provide the requirements for the dyestuff of the cloth. Dingsheng held it was not liable to Wanxing for the defective dyestuff. The court added Huapu Ltd into the action as a third person without an independent claim. It was held that Huapu had breached the terms of the contract under which Huapu promised to use *top-quality* dyestuff – top quality at least means unharmed and free of impurities. The decision was that Huapu was liable to pay damages to Wanxing who actually suffered the loss as the result of Huapu's breach of contract.

The above decision indicates that a third party may acquire contractual remedies in judicial practice although normally they cannot get these remedies from substantive laws. The rule of third person in action avoids unsatisfactory results of sticking to the privity doctrine. The cases equivalent to *St Martins*, *Darlington* and *Panatown* are likely to be dealt with by the rule of *third persons in action* in China, so that the building owners or subsequent building owners may finally recover their loss from contractors. Its way to deal with the cases involving more than three parties is simple and easy. Indeed the courts should have the right to make a decision according to the particular facts of cases; this is similar to the situation in Common Law systems that

⁶⁷² Jin Pengnian, Study on Typical Cases in Commercial Transactions, Intellectual Property Press (2003) 156

the courts can establish exceptions to the privity doctrine; and also similar to the situation in France where the courts solve the problem beyond privity by reason of specific types of contracts and particular facts. Generally speaking, the more explicit a concept is, the more convincing it is. For example, the Chinese rule of *a third person in action* without explaining the reason why an obligor must take liability for breach of contract to a third party, makes that decisions seem not convincing. In the *Wangxing* case, the ending is satisfying – the promisor who broke his promises was asked to pay for damages, whereas the third party who suffered loss should get remedies. But there must be a *link* to connect the two parties' relations and the *link* should be a specific theory or concept justifying the above decision.

6.5 Conclusion

As discussed above, the third party rule will not solve all the problems concerning third parties' loss caused by breach of contract. The typical problem is the legal black hole problem which is characterised as the separation of a right for remedies from loss. The problem also exists in China, but will not be solved by the proposed privity reform. Therefore, some concrete solutions in other countries may be helpful to the Chinese law reform.

First, generally speaking, there are two approaches to deal with it: one is to establish exceptions to the rule that a plaintiff can recover damages for his own loss; another is to create exceptions to the privity doctrine. By the application of the first approach, an obligee is awarded damages in respect of a third party's loss. The English narrow ground solution and the German notion of transferred loss belong to this category although they are based on different reasoning. That the promisee is liable for the third party's loss is the key feature for justification of the narrow ground. As Lord Millet observed in *Panatown* case: "*Compensation for a third party's loss is*

a contradiction in terms. It is impossible on any logical basis to justify the recovery of compensatory damages by a person who has not suffered the loss in respect of which they are awarded unless he is accountable for them to the person who has."⁶⁷³

However, in the *St Martins*, *Darlington* and *Panatown* cases, the facts are that the employers had no liability to the building owners. In the *St Martins*, the employer assigned the benefit of the building contract to the subsequent owner of the building and would no longer be responsible for the loss suffered by the owner. The cost of remedial work was paid by the employer in first instance but recovered by them from the building owner. In the *Darlington*, the employer assigned all rights against the contractor to the land owner and also made an agreement with the owner that they would not be responsible for defective construction work. Similarly, in the *Panatown* case, the employer was not answerable to the site owner in respect of defects in the building. Obviously, in these cases if the employers were liable for the owners' loss, there would be no black hole problem. The solution would be very simple – just to decide how to measure the promisee's damages suffered by the promisor's breach of contract.

Experience shows that in reality businessmen would rather not be involved in an action if they themselves suffer no loss and also are not responsible for another one's loss. However, in the *St Martins* and *Panatown* cases, the employers did claim damages for the building owners' loss. The explanation is that in *St Martins*, the employer and subsequent building owner were wholly owned subsidiaries of holding company, while in the *Panatown* case, the employer and the site owner were members of the same group of companies. In both cases, the employers were chosen to enter into the contract for tax reasons. In this regard, the German notion of transferred loss which is based on the rationale of special relationships between a promisee and a third party seems more suitable to be applied in these cases and therefore gives a more

⁶⁷³ [2000] 3 WLR 1005

satisfactory answer to the questions: why does a promisee get damages in respect of a third party's loss, and is it possible that damages awarded would be handed over from the promisee to a third party? If the equivalent cases happen in China, the notion of transferred loss may be preferred.

Secondly, in the absence of a special relationship between a promisee and a third party, the solution to solve a third party's loss through a promisee's claim may not be applicable. Therefore, the creation of exceptions to the privity doctrine may be considered. For example, in the *Darlington* case, the building owner brought an action himself. Had the tripartite agreement not been made, the 1999 Act might not be applied even the Act was in force at the material time. In this situation, the courts would support the building owner's claim for damages by using other concepts or techniques as they did in the past cases. For example, the technique in the *Darlington* could be agency, and the assignment agreement between the employer and the building owner does not rebut its application because the result of assignment itself is contrary to the parties' intention and expectation.

In the Chinese case *Qin Shan Ltd. v Futaixiang Ltd*, the assignment agreement which provided that the obligee assigned the rights under the contract with the obligor to its sub-buyer was invalid because the obligee had not informed the obligor about it. The obligee was co-defendant with the obligor. The sub-buyer's averment that the obligee had to take responsibility for its fault was supported by the court.⁶⁷⁴

In other two cases *Spinning Mill v Kelun Cotton Mill & Jianshe Cotton Mill*⁶⁷⁵ and *Maoyi Corporation v. Tucan Company & Susu Clothing Factory*,⁶⁷⁶ the benefits

⁶⁷⁴ Zhu Mingshan, *Typical Cases and Application of Statutes – Contracts for sale*, Law Press 2003, p.196

⁶⁷⁵ The case is decided in 1994. See Wang Liming: *Case Studies in Chinese Civil Law*, (1998) Law Press, p.148.

⁶⁷⁶ Wang Liming, *Case studies in Chinese Civil Law*, (1998) Law Press 1998, p.241. See Chapter two, note 49

to receive the goods from obligees to sub-buyers were assigned from the obligees to sub-buyers, but no contract term provided concerning assignment of rights under the contract. The difficulty arose from the agreements between the obligees and the sub-buyers which released the obligees' liability to the latter. In both cases, the obligee refused to bring an action because they suffered no loss themselves. The sub-buyers should be allowed to claim damages due to the particular facts in these cases.

In the *WanXing Company v Dingsheng Ltd*,⁶⁷⁷ the obligor promised to do dyeing work for the obligee's cloth. The obligee made it into dresses and sold the dress to the plaintiff. The dyestuff contained harmful substance but the obligor was not responsible for it to the plaintiff. If the obligee had brought the action, the problem could be solved by the notion of transferred loss – the contract between the obligee and the plaintiff meant they had special relationship. In this case the obligor ignored the plaintiff's request asking it to claim damages from the obligor. The plaintiff's right to claim damages from the defendant should be upheld due to its particular facts.

Finally, in order to solve a third party's loss problem, the Chinese courts should be allowed to make use of the current techniques, such as agency, trust and assignment to solve a third party's loss problem according to particular facts of cases. In addition, the courts should also feel free to develop new exceptions to the rule of privity and the rule that a plaintiff can recover his own loss when it is appropriate to do so. On the other hand, where the similar problems in some types of contracts repeatedly arise in a certain business area, if the exceptions are applied so frequently in certain types of cases and circumstances, the exceptions could be provided in contract laws or specific laws. For example, in the statutes on construction contracts, it may provide some kind of protection for site occupiers' interest when they are not parties to the building contracts. By application of statutory provisions it will be more

⁶⁷⁷ Above note 84

certain and straightforward to deal with the cases. This will especially benefit China, in which decisions are made mostly on legislation.

CHAPTER 7

CONCLUSION

7.1 Theoretical framework for the rule of third party right in China

7.1.1 Reasons for the Chinese reform

With the reform of the Chinese economic system beginning in 1979, the market economy gradually replaced the planned economy. During the period of transition for the economic system, three important contract statutes – the Economic Contract Law 1981, the law of Economic Contract Involving Foreign Interests 1985 and Law and the Technology Contract Law were established 1987. The freedom of contract was established as a principle in the contract laws. The Chinese Civil Code was promulgated in 1986, which confirms that the freedom of contract is a fundamental principle in contract laws. In 1999, three contract statutes were abolished and a new Chinese Contract Law came into being. The 1999 Contract Law highlights the principle of freedom of contract and this fundamental principle shall be embodied throughout the whole statute. It also emphasises that the purpose of the Contract Law is to protect contracting parties' lawful rights and to realize their expected interest in transactions.⁶⁷⁸

Under this principle and the aims of the law, the question arises: if contracting parties intend to confer a right under the contract to a third party, why cannot their intention be recognised by the law? Article 64 of the Chinese Contract Law provides that where contracting parties agree that the obligor should perform contractual

⁶⁷⁸ Article 1, Chinese Contract Law 1999

obligations to a third party, if the obligor fails to fulfill the obligations or his performance does not satisfy the contractual provisions, he holds liabilities only to the obligee for breach of contract. Under this article, the third party only has the right to accept the performance but has no right to claim remedies. Separation of the right of acquiring benefits and the right for remedies causes many problems in practice. First, the obligee may not or cannot bring an action for a third party's loss. This may happen if the obligee cannot be found, has died or is out of business. Or the obligee refuses to bring an action. Secondly, this provision contradicts the rule that the plaintiff can only claim damages for his own loss.⁶⁷⁹ In summary, as a result, three main problems are caused by the privity doctrine in China.

1. In order to solve the above problems, the Chinese courts directly use the fundamental principles, such as justice, honesty and trustworthiness,⁶⁸⁰ as the basis of their decisions to support third parties' damages. Although the courts are allowed to directly use these principles which are explicitly provided in the Contract Law,⁶⁸¹ it seems this is not the best solution. The courts normally explain the principles in a flexible way, and the application of the principles leads to uncertainty and instability in judicial practice. A number of cases discussed in chapter two shows that the application of the principles results in inconsistent decisions.

2. It is plain that article 64 was established to allow an obligee to recover

⁶⁷⁹ The rule was established in the Supreme Court's Interpretation of Right of Claim in Actions 1956, Issue no 10833.

⁶⁸⁰ The principle of honesty and trustworthiness means objective good faith which is regarded as a norm for the conduct of contracting parties, see above para 1.2.4.2 and 2.2.1.2

⁶⁸¹ Article 5 of the Contract Law provides: the parties shall abide by the principle of fairness in prescribing their respective rights and obligations. Article 6 provides the parties must act in accordance with the principle of honesty and trustworthiness, no matter in exercising rights or in performing obligations.

substantial damages, instead of nominal damages only. If article 64 is regarded as an exception to the rule that a party can recover damages for his own loss only so as to solve the third party's loss. It did not answer the question: how could the third party beneficiary recover the damages from the obligee; if the obligee refuses to handover the damages, is there any remedy available to the third party? This is very likely to happen, especially in those cases where the obligees do not owe responsibilities to the third parties or have released their responsibilities to the latter.⁶⁸² In this regard, I doubt the capability of article 64, as a general rule to be applied in contracts for the third party's benefit, to solve the beneficiary's loss.

3. The courts also use the rule of *third person in action* to solve the problems. Where an obligee brings an action, the third party beneficiary can join the action and claim damages for his own loss. Or if a third party brings an action against the obligee, the court may ask the obligor to join in the action. In these situations, the courts may hold that the obligor is liable to pay damages to the third party.⁶⁸³ The problem arising from this approach is that allowing a third party to recover his consequential loss from an obligor does not accord with the rule that damages for breach of contract shall be limited within the obligor's foreseeability.⁶⁸⁴ For example, in the

⁶⁸² Examples are *Spinning Mill v Kelun Cotton Mill & Jianshe Cotton Mill*, see Wang Liming: "Case studies in Chinese Civil Law", Law Press 1998, p.148; *Maoyi Corporation v. Tucan Company & Susu Clothing Factory*, Wang Liming: "Case studies in Chinese Civil Law", Law Press 1998, p.241

⁶⁸³ Examples are *LiFeng Gongmao Ltd v Xin Gang Lipin Company*, see Applied Legal Science Research Office, People's Court Cases – Commence, Vol. 1, Law Press, (2002) pp69-77; *Zhong Hua International Trade Company v Hengshui Chemical Engineering Ltd*, see Wang Liming, 'Cases Studies in Chinese Contract Law', Zhengfa University Press (1999), 172-177; *Yong Long v Lida & Korean Zhushi Company*, see Applied Legal Science Research Office, People's Court Cases – Commence, Vol. 1, Law Press, (2002) pp78-87

⁶⁸⁴ Article 113 of the Contract Law: "Where one party to a contract fails to perform the contract obligations or its performance fails to satisfy the terms of the contract and causes losses to the other party, the amount of compensation for losses shall be equal to the losses caused by the breach of

WanXing Company v Dingsheng Ltd,⁶⁸⁵ the third party suffered loss of profits of selling dresses to a wholeseller in Vietnam because the obligor used contaminated dyestuff to the cloth. The third party's claim for damages from the obligor was awarded. But it was not reasonable to allow the third party to recover the loss of profits where the obligor could not have foreseen that the third party had bought the dresses and exported them to a foreign company.

Based on comparative study of Common Law and Civil law, many countries' laws have recognised third party beneficiaries' rights in contracts. Experiences from these countries show that sticking to the privity doctrines causes unsatisfactory results in practice, and recognising third party beneficiaries' right in the best way to solve the problems. Their experiences and rule of third party are very helpful to the Chinese law reform.

7.1.2 Framework of the third party rule in China

7.1.2.1 Primary issues

A set of rules concerning a third party beneficiary's right is recommended to be created in China. These rules must solve the following problems: in what circumstances will a third party be allowed to enforce a contract? What remedies in the Contract Law will be available to a third party? Are contracting parties able to vary or cancel the contracts, in which third party beneficiaries' rights are involved? And what defences will be available to an obligor in a third party's action?

contract, including the interests receivable after performance of the contract, provided not exceeding the probable losses caused by the breach of contract which has been foreseen or ought to be foreseen when the party in breach concludes the contract."

⁶⁸⁵ Jin Pengnian, Study on Typical Cases in Commercial Transactions, Intellectual Property Press (2003) 156

The central question is in what circumstances a third party will get an enforceable right on the contract. Different tests are established in Common Law systems and Civil Law systems. Since the privity reform in China is recommended on the ground of the purposes of Contract Law and the freedom of contract principle, the dual intention test established in the English 1999 Act is better to be adopted. In addition, considering multi-layered jurisdiction and diverse capabilities of judges in China, the dual intention test which causes less uncertainty is preferred. Therefore, under the proposed third party rule, the condition for a third party to acquire a right to enforce a contract in Chinese Contract law will be that contracting parties not only have an intention to confer a benefit on the third party, but also have an intention to allow it to sue on the contract.

Where contracting parties have an intention to allow a third party beneficiary to enforce the contract, they must also have an intention to allow the beneficiary to get full remedies provided in the Chinese Contract Law unless they expressly agree to the beneficiary is not entitled to some kinds of remedies. On the other hand, when a third party brings an action for remedies, all existing rules relating to specific performance,⁶⁸⁶ remedy,⁶⁸⁷ damages⁶⁸⁸ and deposit⁶⁸⁹ must be applied automatically..

⁶⁸⁶ Article 110 provides: "where one party to a contract fails to perform the non-monetary debt or its performance of non-monetary debt fails to satisfy the terms of the contract, the other party may request it to perform it except under any of the following circumstances: (1) It is unable to be performed in law or in fact; (2) The object of the debt is unfit for compulsory performance or the performance expenses are excessively high; or (3) The creditor fails to request for the performance within a reasonable time period."

⁶⁸⁷ Article 111 provides: "if the quality fails to satisfy the terms of the contract, the breach of contract damages shall be borne according to the terms of the contract agreed upon by the parties. If there is no agreement in the contract on the liability for breach of contract or such agreement is unclear, nor can it be determined in accordance with the provisions of Article 61 of this Law, the damaged party may, in light of the character of the object and the degree of losses, reasonably choose to request the other party to bear the liabilities for the breach of contract such as repairing, substituting the goods, or reducing the price or remuneration."

⁶⁸⁸ Article 112 provides: "where one party to a contract fails to perform the contract obligations or its performance fails to satisfy the terms of the contract, the party shall, after performing its obligations or taking remedial measures, compensate for the losses, if the other party suffers from other losses."

Even if a third party's right is involved, contracting parties' rights in the contract are still protected but subject to some restrictions. These rules concern parties' right to vary or cancel the contracts. In principle, contracting parties can freely decide when a third party's right is secured, and what the precondition is for a third party to acquire the right. But these intentions must be expressly provided in the contract so that the third party will know that. In the absence of express contractual provisions, a statutory test will be applied. Various tests to secure a third party's right are adopted in different countries' laws. These tests normally are a third party's awareness, intimation to a third party, a third party's acceptance, a third party's reliance and that parties put the contract out of their control. By contrast, the test of reliance and the test of putting the contract out of parties' control are the better tests to be adopted in the Chinese Contract Law. As discussed in chapter four, the other three tests put much more restrictions on parties' right of variation and cancellation so that it may cause injustice to the parties. In addition to the test of reliance, a special test is applicable – a third party's right is secured after the promisee's death if his right is vested at the time of the death of the obligee.

In an action brought by a third party beneficiary, defences are also available to an obligor. Most countries establish a general rule that the defences available to the obligor must arise from the contract.⁶⁸⁹ Under the Chinese Contract Law, defences are available to an obligor if the contract is treated as invalid or voidable. Where an obligee fails to perform its counterclaim, the obligor can refuse to fulfill its contractual obligations. This is provided in the Contract Law as 'three kinds of defences based on the obligee's action or inaction,'⁶⁹¹ and in practice the obligor also

⁶⁸⁹ Article 116 provides: "where the parties to a contract agree on both breach of contract damages and a deposit, when one party violates the contract, the other party may choose to apply the breach of contract damages clause or the deposit clause."

⁶⁹⁰ International Encyclopaedia of Comparative Law – Third Party Beneficiaries, p47

⁶⁹¹ Article 66 provides that: "if both parties have obligations toward each other and there is no order of priority in respect of the performance of obligation, the parties shall perform the obligations

makes use of these rules to set off the obligee's damages. Generally speaking, in order to avoid the prejudice of the obligor's rights, the above defences shall also be available to it in an action brought by a third party, unless the contract contains an express provision to the effect that the obligor may not raise a defence against the third party. In addition, a third party may owe a duty to cooperate or assist the obligor to perform contractual obligations. Its failure to do so may constitute the reasons for the obligor to defend against the third party's claim or to assert a set off. It is true that a third party is likely to encounter an obligor's defences, but it may know nothing about the cause of defences. However, the general rule that the third party's status will not worse off because his taking the benefit in the contract ensures no injustice will be caused to the third party.

7.1.2.2 The proposed third party rule in China and the existing statutes

First, existing statutory provisions of the privity doctrine should be preserved. There are some existing statutes concerning a third party's right. These provisions are established to regulate particular types of contracts. One situation will be that a third party will not be able to take the advantage from the proposed third party rule, but will still get the benefits from the existing provisions. For example, under article 272

simultaneously. One party has the right reject the other party's request for performance if the other party's performance. One party has the right to reject the other party's corresponding request for performance if the other party's performance does not meet the terms of the contract." Article 67 provides that: "where both parties have obligations towards each other and there has been an order of priority in respect of the performance, and the party which shall render its performance first has not rendered the performance, the party which may render its performance later has the right to reject the other party's request for performance. Where the party which shall render its performance first violates the terms of a contract while fulfilling the obligations, the party which may render its performance later has the right to reject the other party's corresponding request for performance." Article 68 provides that: "one party, which shall render its performance first, may suspend its performance, if it has conclusive evidence that the other party is under any of the following circumstances: (1) Its business conditions are seriously deteriorating; (2) It moves away its property and takes out its capital secretly to evade debt; (3) It loses its commercial credibility; (4) Other circumstances showing that it loses or is possible to lose the capacity of credit."

of the Chinese Contract Law,⁶⁹² a contractor and a subcontractor must hold joint liability to the employer for the construction work, while the employer will not be able to sue the subcontractor based on the proposed third party rule unless the subcontract contains an express term providing the employer has such a right. Under article 32 of the Regulation of Construction Quality, sub-purchasers and occupiers have the right to request repair of the building from the contractors within the warranty period, but they will have no right to enforce the warranty term as a third party beneficiary. Another situation will be that a third party may get the right of contract under both of the existing law and the third party rule. For example, a beneficiary in a life insurance policy – he is an intended beneficiary in the contract, and his right has been legislatively confirmed in the Insurance Law.⁶⁹³

A question arises here is: since some specific statutory provisions represent legislatures' choices to regulate particular types of contracts or transactions, will the application of the third party rule be excluded if a third party's right in a contract contradict these statutes? The answer to the question is based on the basic policy of

⁶⁹² Article 272 of the Contract Law provides: "With the consent of the contract letting party, the general contractor or the contractors for survey, design or construction may assign part of the contracted work to a third party. The third party shall assume joint and several liability to the contract letting party together with the general contractor or the contractors for survey, design or construction in respect of its work achievements. A contractor may not assign the whole contracted project to a third party or divide the whole contracted construction project into several parts and assign them respectively to third parties in the name of subletting."

⁶⁹³ Article 24 of the Insurance Law provides that: "the insurer shall, after receiving claims of indemnity or payment of insurance benefit from the insured or beneficiary, timely come to a decision, as for those within the insurance liability, he shall execute the liability of indemnity or payment of insurance benefit within 10 days after reaching an agreement over the indemnity or payment of the insurance benefit with the insured or the beneficiary. If the insurance contract has the stipulations on insured amount and the period of indemnity or payment. The insurer shall, as contracted, execute the liability of indemnity or payment insurance the insurance benefit. Apart from paying the insurance benefit, the insurer who fails timely to execute the liability as provided in the preceding paragraph shall indemnify the insured or beneficiary for losses therefrom. No unit or individual may illegally interfere the insurer from executing the liability over indemnity or payment of the insurance benefit, and may either restrict the rights of insured or the beneficiary in obtaining the insurance benefit. The insured amount means the maximum measure of indemnity or payment of the insurance benefit by the insurer."

privity reform and the principles of the Contract Law, that is, intentions of contracting parties to confer legal rights on third parties should be upheld. Therefore if parties have an intention to allow a third party to enforce the contract, their intention has priority to be recognised by the law, unless such an intention falls within the scope of article 52 of the contract which provides:

A contract shall be null and void under any of the following circumstances: (1) A contract is concluded through the use of fraud or coercion by one party to damage the interests of the State; (2) Malicious collusion is conducted to damage the interests of the State. A collective or a third party; (3) An illegitimate purpose is concealed under the guise of legitimate acts; (4) Damaging the public interests; (5) Violating the compulsory provisions of the laws and administrative regulations.

For example, if a building contract contains a term which excludes the subcontractor's joint liability for the construction work to the employer, the subcontractor will not get the benefit from this agreement under the third party rule because article 272 of the Contract Law is a compulsory statutory provision. In addition, if a contract contains an exemption clause for the third party's benefit, the third party's enforcement on the clause is subject to article 53 of the Contract law:

The following immunity clauses in a contract shall be null and void: (1) those that cause personal injury to the other party; (2) those that cause property damages to the other party as a result of deliberate intent or gross fault.

Under this rule, where a building contract contains a provision to release the subcontractor's liability for personal damage caused during the construction work, the subcontractor will not get the benefit from this provision.

Secondly, the proposed third party rule will not affect third parties' right to bring actions against obligors based on the tort law. A third who suffers personal damage or

property damage as the result of the obligor's breach of contract has the right to sue the latter in tort or on the contract. It is legislatively confirmed that a party to a contract shall have the right to choose to sue relying on contract law or on tort law. Article 122 of the Contract Law provides that:

In case that the breach of contract by one party infringes upon the other party's personal or property rights, the aggrieved party shall be entitled to choose to claim the assumption by the violating and infringing party of liabilities for breach of contract according to this Law, or to claim the assumption by the violating and infringing party of liabilities for infringement according to other laws.

This rule will also take effect to a third party if he has the right to enforce the contract under the proposed third party rule. For example, A contracted with B to build a refrigerated warehouse. A and B agreed that the sub-purchaser of the warehouse will get the benefits and rights under the contract. Later C bought the warehouse. The warehouse was found to be defective because of its bad design and thereby caused damage to C's goods. Under the proposed third party rule, C would have the right to bring an action on the contract, and also it can choose to sue B on article 41 of the Regulation of Construction Quality, which provides that where the construction work is found to be defective during the warranty period, the contractor is liable to repair it and pay damages for losses caused by the defective work.

7.2 Recommendations and open-ended research

Privity reform and the establishment of a third party rule is proposed based on the purposes of the Chinese Contract Law, the fundamental principles, the current situation of legal system, the current judicatory situation and comparative study of the third party rules in other countries. On the other hand, as discussed in chapter six, the proposed third party rule will not solve all the problems concerning a third party's loss

caused by an obligor's breach of contract. In this regard, I would make the following recommendations if the new third party rule is to be adopted in China:

1. The courts keep the right to use the existing legal theories, such as agency, assignment and trust, to interpret contracting party's intentions and the arrangement of their transactions. The interpretation can be construed from contract language, supplemental agreement and surrounding circumstances. For example, in *Spinning Mill v Kelun Cotton Mill & Jianshe Cotton Mill*⁶⁹⁴ and *Maoyi Corporation v. Tucan Company & Susu Clothing Factory*,⁶⁹⁵ the obligees sold the products to the buyers after they ordered products from the obligors. Then the obligors promised to deliver the goods to the buyers directly. The obligees and the buyers made an agreement that the benefits under the contract between the obligees and the obligors were to be transferred to the buyers and therefore the obligees's liabilities to the buyers would be released. The obligors failed to perform the promises satisfactorily. In both cases, the obligees did not expressly agreed to assign the rights of action to the buyers. The majority of judges in the *Maoyi* case held that there must have had been an implicit agreement between the obligee and the buyer that the former would assign the rights of contract to the latter, when they agreed to release the former's liability to the latter arising from their own contract.
2. The courts' discretion to use the basic principles to solve the problem of a third party's loss must be restricted to the very exceptional circumstances. Some concrete solutions developed in other countries can be introduced into China. For example, the English notion 'narrow ground' and German notion 'transferred loss' could be applied to cases concerning a third party's loss in

⁶⁹⁴ The case is decided in 1994. See Wang Liming, Case studies in Chinese Civil Law, (1998) Law Press, p.148.

⁶⁹⁵ Wang Liming, Case studies in Chinese Civil Law, (1998) Law Press, p.241.

contracts for carriage of goods and construction contracts.

3. Specific laws aim to regulate particular types of contracts or particular issues in certain transactions. Where a same or similar problem frequently happens in a certain type of contracts, it is necessary to establish or develop particular rules to regulate it. For example, in order to deal with disappointed legatees' loss caused by negligence of notary public, the Chinese Testament Regulations was promulgated in 2000. Under this statute, the notary public is liable for its fault in making a testament and thereby ought to pay compensation for the damage.⁶⁹⁶ The establishment of specific laws could be helpful to solve the black hole problem. For instance, a statutory may be created concerning the protection of land users' and building owners' interests when they are not parties to construction contracts. If the problem in the *Spinning Mill* cases and the *Tucan* case happens occasionally, a specific statutory provision could be added in the Contract Law as 'where an assignor assign its benefits under another contract to the assignee, the rights under that contract will also be assigned to the assignee accordingly, unless a contrary agreement is expressly made; where an assignor assigns its benefits and rights under another contract to the assignee but the assignment is invalid because that contract contains an assignment prohibition clause, the assignor shall pay damages to the assignee who suffers loss as a result.' Explicit statutes are preferred because of the current situations of the Chinese multi-layered jurisdiction, the structure of judicial authority and diverse capabilities of judges.

The above recommendations are based on a theoretical analysis. The framework of the third party rule is also proposed on the assumption. What kinds of difficulties or problems will possibly develop when the proposed third party rule is *actually* applied

⁶⁹⁶ Article 24 of the Chinese Testament Regulations

in Chinese Law remains unknown. In addition, with the development of the Chinese economy, new legal problems concerning a third party's interest in a contract are likely to arise. Now, the Chinese legislature is preparing for the draft of a new civil code. The questions - will a general third party rule be established? What other rules related to third party right will be made or changed? What will these rules in the new civil code affect the establishment of a general third party rule? These questions leave a great space for further research. The development of the third party rule in other countries and study on their future experiences will also be helpful to direct a way for the improvement of the third party rule in China.

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